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EQUITY IN TIMES OF MORTGAGE CRISIS

Steven W. Bender*

Editors' Synopsis: The notion that equity is available to both lenders and borrowers in foreclosure is widely accepted. Yet, during times of a mortgage crisis, equity does not act to avoid certain injustices. This Article, premised on the historical and modern applications of equity, suggests increasing the role of equity without completely disregarding contractual obligations between lenders and borrowers.

"Equity will not suffer a wrong without a remedy."¹

"In a suit in equity, the Court is vested with jurisdiction to do that which ought to be done."²

"Equity abhors forfeitures."³

"If equity can mold its remedies to meet conditions as they arise, then equity should not fail in this emergency to hold the scales even."⁴

"A [law] student came to a dean asking to study equity.

First you must study law, said the dean, and sent the student away. Three years later, the student returned. I studied law It was a worthless endeavor. The law is unjust, formalistic, nonsensical, and hopelessly confused. I have never been so frustrated in my life as in the last three years.

Now you are ready to study equity, said the dean."⁵

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¹ Fed. Title & Mortg. Guar. Co. v. Lowenstein, 166 A. 538, 542 (N.J. Ch. 1933) (internal quotation marks omitted).

² Emigrant Mortg. Co. v. Corcione, 900 N.Y.S.2d 608, 614 (N.Y. Sup. Ct. 2010), *vacated*, Order on Motion, No. 2009-28917, 2010 WL 7014850 (N.Y. Sup. Ct. Oct. 14, 2010).

³ Looney v. Farmers Home Admin., 794 F.2d 310, 312 (7th Cir. 1986) (quoting Skendzel v. Marshall, 301 N.E.2d 641, 650 (1973)) (involving an installment land contract—a mortgage substitute—remedy of forfeiture).

⁴ Bank of Manhattan Trust Co. v. Elldo Corp., 265 N.Y.S. 115, 124 (N.Y. Sup. Ct. 1933), *rev'd on other grounds*, 271 N.Y.S. 522 (N.Y. App. Div. 1934).

⁵ James Grimmelmänn, *Koans of Equity*, 58 J. LEGAL EDUC. 472, 473 (2008).

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I. INTRODUCTION

These opening quotes suggest a grandiose role for equity, particularly in times of mortgage crisis when borrowers who face an epidemic of residential foreclosures grasp for relief. In the recent subprime mortgage crisis alone, more than 3.5 million U.S. households lost their family homes to foreclosure.⁶ Despite the promise within sweeping maxims of equity, state

⁶ See ACLU, JUSTICE FORECLOSED: HOW WALL STREET'S APPETITE FOR SUBPRIME MORTGAGES ENDED UP HURTING BLACK AND LATINO COMMUNITIES 5 (2012), available at <http://www.aclu.org/racial-justice/justice-foreclosed-how-wall-streets-appetite-subprime-mortgages-ended-hurting-black>. A later article in 2012 pegged the subprime foreclosure count at

legislatures did the heavy lifting to protect borrowers during the Great Depression and the subprime mortgage crisis. With the exception of a few trial court judges in New York, equity made no great strides during the subprime crisis to rescue borrowers facing foreclosure and deficiency judgments on underwater residences.⁷ Rather, equity followed past precedent (as it did during the Great Depression) to afford relief in narrow, conservatively applied situations. That relief rarely resonated with the broader needs of subprime borrowers—they often needed more time to figure out their options before losing their homes, including meaningful loan modifications to reduce loan principal to current value and protection from deficiencies left owing after foreclosure.

This Article focuses on both the historical experience of equity and its unrealized potential in times of economic and mortgage crises. Mindful that equity exists to protect both borrowers and lenders, the proposals offered below are pragmatic attempts to balance the interests of both parties to the mortgage loan in ways that do not dramatically overturn contractual or investment-backed expectations. Instead, equity can delicately and better balance uneven scales of fairness that sometimes appear in times of emergency, and consistent with the most quoted equitable maxim, do what ought to be done.

Before suggesting reforms for equitable intervention in times of economic crisis, this Article surveys in Parts II and III the origins and modern applications of equitable relief for mortgage loans. Part IV recounts the case law experience for equity and related theories of borrower protection during the three primary mortgage emergencies of the past century—the Great Depression, the savings and loan crisis, and the subprime mortgage crisis—thereby placing the latest crisis in historical perspective. Blending legislative interventions and kindred theories from common law contracts, Part IV also situates the strengths and shortcomings of judicial equity within these alternate sources of borrower protection. Finally, Part V anticipates the next mortgage crisis and offers suggestions

nearly 4 million. See Morgan Brennan, *The Foreclosure Crisis Isn't Over Just Yet*, FORBES (Dec. 1, 2012), <http://www.forbes.com/sites/morganbrennan/2012/12/01/the-foreclosure-crisis-isnt-over-just-yet/>. In turn, the foreclosure crisis displaced about 10 million people from their homes. See Laura Gottesdeiner, *10 Million Americans Have Had Their Homes Taken Away by the Banks—Often at the Point of a Gun*, ALTERNET (Aug. 1, 2013), <http://www.alternet.org/investigations/10-million-americans-foreclosed-neighborhoods-devastated?>.

⁷ See generally Mark Fass, *Low-Key Judge Raises the Roof with Foreclosure Rulings*, N.Y.L.J., July 19, 2010, available at <http://www.alm.law.com/jsp/article.jsp?id=1202463642417&slreturn=20140211135436>.

for an expanded but balanced role of equity in remedying the worst injustices that might emerge.

II. ORIGINS OF EQUITY APPLIED TO MORTGAGES⁸

The roots of judicial equity in modern U.S. foreclosure proceedings extend to England.⁹ Beginning around the fourteenth century, mortgages were styled as a conveyance deed from the borrower (mortgagor) to the lender (mortgagee), yet subject to a condition subsequent that if the borrower performed under the promissory note, foremost by paying the principal indebtedness on the due date (known as law day), title would automatically revert to the borrower.¹⁰ Should the borrower default in paying interest or principal, the condition would fail and the lender would acquire indefeasible fee simple title.¹¹ Surely, the immediacy of the deed condition could work an injustice. What if the borrower's horse suffered an accident on the way to deliver the final payoff (or any interest payment)? What if the borrower fell ill on that day? What if the borrower was robbed in transit or could not locate the lender on law day? The upshot is that while no remedy existed in law for this misfortune, the borrower could resort to the King's Chancellor (later the courts of equity) to explain the injustice and gain relief by pointing to fraud, accident, or some other equitable ground for the payment lapse.¹² Typically, the equitable remedy consisted of allowing the borrower to redeem (repurchase) the mortgaged property from the lender by paying the principal amount owed and interest on the debt. By the end of the seventeenth century, equity courts accorded the delinquent

⁸ Part II is based on the discussion in the author's textbook. See STEVEN W. BENDER ET AL., *MODERN REAL ESTATE FINANCE AND LAND TRANSFER: A TRANSACTIONAL APPROACH* 98-102 (5th ed. 2013).

⁹ See *id.* at 98.

¹⁰ See *id.* at 99. Until the U.S. government subsidized mortgage lending through the Federal Housing Administration beginning in 1934, and the 30-year fully-amortized mortgage payment period became custom, mortgage loans tended to have no, or only partial, amortization during their much shorter loan terms. Therefore, the prospect of a significant balloon payment of principal made law day especially consequential in the life of the early mortgage loan.

¹¹ See *id.*

¹² See R.W. TURNER, *THE EQUITY OF REDEMPTION: ITS NATURE, HISTORY AND CONNECTION WITH EQUITABLE ESTATES GENERALLY* 24 (1931) (tracing the first equitable interventions of the Chancellor on behalf of mortgagors to the reign of Queen Elizabeth in the second half of the sixteenth century).

borrower a right to redeem and regain the property as a matter of right even in the absence of some compelling excuse.¹³

From the lender's perspective, recognition of the equitable right of redemption proved problematic. Should the borrower convince the equity court of an unconscionable forfeiture (or, later in equity's history, merely invoke equity's jurisdiction), how could the lender refurbish or sell the property with the specter of redemption at some future date? Although the equitable doctrine of laches might penalize the borrower for any unduly prejudicial delay, the uncertainty of redemptive relief sent lenders themselves to equity—in advance of any plea by the borrower—asking equity to cut off (foreclose) the borrower's potential equitable right of redemption. Evidencing the duality of equity in hearing pleas from the mortgagee as well as the mortgagor, equity responded by ordering the borrower to repay the overdue outstanding balance within a specified period of time in order to regain the property. The modern day foreclosure sale was born from this “strict foreclosure” procedure, by which the lender was allowed to keep the mortgaged property in fee simple upon the borrower's failure to redeem within the stipulated time period.¹⁴ By statute in most U.S. jurisdictions today, lenders must foreclose the borrower's (equitable) right of redemption in accordance with statutory procedure. Such procedures may involve judicial foreclosure proceedings followed by a sheriff sale, or in many jurisdictions that authorize the deed of trust or a mortgage power of sale, a private sale without judicial involvement.

¹³ See RESTATEMENT (THIRD) OF PROP.: MORTGS. § 3.1 cmt. a (1997); David A. Super, *Defending Mortgage Foreclosures: Seeking a Role for Equity*, 43 CLEARINGHOUSE REV. 105 (2009).

¹⁴ A handful of U.S. jurisdictions still authorize strict foreclosure. See CONN. GEN. STAT. § 49-24 (2013); VT. STAT. ANN. tit. 12, §§ 4528, 4531 (2002). Equity initially developed the decree of foreclosure by sale to cut off the borrower's equitable right of redemption. See Morris G. Shanker, *Will Mortgage Law Survive?: A Commentary and Critique on Mortgage Law's Birth, Long Life, and Current Proposals for its Demise*, 54 CASE W. RES. L. REV. 69, 76 (2003) (describing how the strict foreclosure decree evolved to one of a foreclosure by sale). However, most jurisdictions eventually codified and specified statutory foreclosure procedures. See *id.* Equity—a financial term commonly used to describe the borrower's stake in the mortgaged property over and above the amount owed on the mortgage—reflects the equitable origins of the foreclosure process. See Douglas Laycock, *The Triumph of Equity*, 56 L. & CONTEMP. PROBS. 53, 68 (1993).

III. MODERN APPLICATIONS OF EQUITY IN FORECLOSURES

Following the merger of law and equity into a single court,¹⁵ U.S. courts continue to apply equitable principles and oversight to judicial and non-judicial foreclosures.¹⁶ In the modern U.S. foreclosure procedure, the equitable right of redemption refers to the time period before the foreclosure sale within which the borrower must repay the accelerated loan indebtedness to avoid losing all title in the foreclosure sale.¹⁷ Prompted by the depression of the 1820s, many jurisdictions enacted statutory redemption laws—distinct from the equitable right of redemption that operates before the foreclosure sale—which afford the borrower (and often junior lienors) the right to repurchase the property for a specified time after the foreclosure sale by paying the foreclosure price to the purchaser.¹⁸

Equity's modern application that is closest to the traditional equitable right of redemption (as first applied in England) occurs in the context of the installment land contract. Enforced in most U.S. jurisdictions, the installment land contract is an arrangement of seller financing whereby the seller retains title until the borrower has successfully paid every installment. Pursuant to a contractual forfeiture clause, the buyer's failure to timely pay an installment, usually following a contractual or statutory cure period, results in the buyer-borrower's forfeiture of any interest in the property.¹⁹ Without the benefit of a foreclosure sale, the buyer (vendee) under an installment land contract might suffer the same inequity of the mortgagor before the advent of the statutory or equitable foreclosure sale. For example, the vendee might fail to make the last of a multi-year series of monthly payments and thus ostensibly forfeit any contractual right to obtain title to the property. As equity once intervened to benefit the mortgagor victimized by the failure of a rigid condition

¹⁵ See WILLIAM Q. DE FUNIAK, HANDBOOK OF MODERN EQUITY 7–8, n.21 (2d ed. 1956) (discussing how the merger began with New York courts in 1848 and how New Jersey retains both a chancery division of equity and a law division in its superior court).

¹⁶ See, e.g., *Krohn v. Sweetheart Props. Ltd. (In re Krohn)*, 52 P.3d 774, 782 (Ariz. 2002) (rejecting an argument that the absence of a statute authorizing courts to use equity powers in nonjudicial foreclosures under a deed of trust deprives them of equitable jurisdiction).

¹⁷ Many deed of trust jurisdictions, while not affording the borrower statutory redemption rights following the sale, give a borrower the right to deaccelerate the loan and terminate the foreclosure sale by paying the arrearages (as opposed to the entire accelerated balance) and reasonable costs of foreclosure to date. See, e.g., MICHAEL T. MADISON, JEFFRY R. DWYER & STEVEN W. BENDER, 2 THE LAW OF REAL ESTATE FINANCING § 8:41 (rev. ed. 2013) (describing the right under Texas law).

¹⁸ See *id.*

¹⁹ See *id.*

subsequent, vendees suffering an undue forfeiture now routinely invoke the equitable jurisdiction of courts to apply the maxim that “equity abhors a forfeiture” and to supply appropriate relief.²⁰

For mortgages and deeds of trust foreclosed by sale in accordance with statutory or judicial procedures, equity need not intervene to relieve the borrower from the forfeiture attendant to the strict deed condition of full and timely payment. Rather, today’s borrower has the benefit of the time period—which is often substantial—necessary to obtain a judicial foreclosure decree ordering sale (likely followed by a statutory redemption period) and, typically, a few months before a nonjudicial sale under a deed of trust. Yet, opportunity remains for equitable intervention during and after the modern foreclosure sale process. Evident in the below review of the application of modern equity principles to foreclosure proceedings, equity tends to be exercised—and rather stingily at best—in certain now-entrenched and well defined circumstances. Thus, in most jurisdictions, lenders might comfortably foresee and avoid the circumscribed application

²⁰ *Id.* § 8.42. Although the case law tends to be fact specific, the most influential factor in awarding equitable relief to the vendee is when the vendee, through payments on the loan or the down payment, property improvements, or appreciation, has acquired substantial equity (value in excess of indebtedness) in the property. *See id.* Another important consideration is whether the vendee abandoned or absconded from the property because equity disfavors that behavior pursuant to the equitable doctrine that those seeking equity must have clean hands. *See Ulster Savs. Bank v. 28 Brynwood Lane, Ltd.*, 41 A.3d 1077, 1085 (Conn. App. Ct. 2012) (quoting *Bauer v. Waste Mgmt. of Conn., Inc.* 686 A.2d 481, 486 (Conn. 1996)) (“The doctrine of unclean hands expresses the principle that where a plaintiff seeks equitable relief, he must show that his conduct has been fair, equitable and honest as to the particular controversy in issue.”). Courts willing to recharacterize the installment land contract as an equitable mortgage in order to prevent an undue forfeiture tend to be flexible in supplying a remedy—most simply by treating the installment land contract as a mortgage demanding judicial foreclosure, and thus supplying the vendee an equitable and, should the jurisdiction mandate it for mortgages, a statutory right of redemption following a foreclosure sale. Other times, the courts might (1) specify an equitable period of redemption without mandating a sale, (2) allow, equitably, the borrower to reinstate the contract by paying just the arrearage instead of the accelerated loan balance, or (3) demand payment of some restitution by the seller to the borrower for unjust enrichment while allowing the seller-lender to retain title. *See MADISON, DWYER & BENDER, supra* note 17, §§ 8:43-8:45.

Recognizing that the installment land contract, in reality, is an end-run around the foreclosure sale protections accorded by statute for the functionally equivalent mortgage or deed of trust, the Restatement (Third) of Property (Mortgages) calls on courts to recharacterize the installment land contract as a mortgage regardless of the particularized equities of the case, thus requiring judicial foreclosure on default for all installment land contracts. *See RESTATEMENT (THIRD) OF PROP.: MORTGS.* § 3.4 (1997). Yet, few jurisdictions follow this approach. *See MADISON, DWYER & BENDER, supra* note 17, § 8:42 (citing only case law in Kentucky and Florida as adopting this public policy recharacterization).

of equity rather than being wary of its intervention in unexpected and punitive ways.

Governing the inception of the foreclosure action, courts have held that equitable considerations apply to the lender's activation of its acceleration clause,²¹ and relatedly, to its initiation of foreclosure (typically the lender invokes its contractual acceleration clause by initiating foreclosure). Despite the possibility of equitable redemption before the foreclosure sale, or deacceleration authorized by statute in many jurisdictions for a deed of trust nonjudicial foreclosure,²² the borrower has a stake in arguing that neither the foreclosure action should have been initiated nor the debt accelerated. In the absence of a statutory right to deaccelerate the loan, the borrower would undoubtedly have trouble raising the funds for a full loan payoff absent a refinance (likely at a higher interest rate given the borrower's record of default) from another lender, or a voluntary sale in advance of foreclosure. Should the borrower have the means to supply just the missed payments, deacceleration in equity would be a desirable outcome. Alternatively, even in a statutory deacceleration jurisdiction, the borrower's liability for contractual late fees, default interest, and reasonable expenses incurred in initiating the foreclosure could stymie exercise of that statutory right. By invoking equity in this context, the borrower is contending that while admittedly in default, compelling circumstances render the lender's push to accelerate and foreclose inequitable and unconscionable.

Still, equity traditionally has been stingy in deeming acceleration or initiation of foreclosure inequitable.²³ As the Restatement (Third) of Property (Mortgages) (Restatement) adopts, the traditional strict approach in equity has been to relieve the borrower of acceleration only when "the mortgagee has engaged in fraud, bad faith, or other conduct making

²¹ See, e.g., *Vonk v. Dunn*, 775 P.2d 1088, 1090 (Ariz. 1989) (en banc) ("[E]quitable considerations specifically apply to acceleration clauses . . .").

²² See BENDER ET AL., *supra* note 8, at 415.

²³ See, e.g., *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 885 (N.Y. 1930) (refusing to award equitable relief to a borrower whose clerk miscalculated payment signed by the company president before his European trip, resulting in a payment shortfall and default justifying acceleration; the payment shortfall resulted from the borrower's own negligence, and judicial equity will not intervene in the absence of fraud, bad faith, or unconscionable conduct). Justice Cardozo's dissent argued the "hardship is so flagrant, the misadventure so undoubted, the oppression so apparent, as to justify a holding that only through an acceptance of the tender [of the shortfall] will equity be done." *Id.* at 889 (Cardozo, J., dissenting). See generally R. Wilson Freyermuth, *Enforcement of Acceleration Provisions and the Rhetoric of Good Faith*, 1998 B.Y.U.L. REV. 1035, 1041 (critiquing the Restatement (Third's) bad faith exception as creating the potential for uncertainty in application).

acceleration unconscionable.”²⁴ As the Restatement comments explain, the strict approach’s focus on lender misconduct leaves unprotected certain “circumstances beyond [the] mortgagor’s control” (such as, presumably, a crop failure or recent job loss) even when the acceleration “will cause extreme hardship.”²⁵ If the lender is not guilty of misconduct—for example, misleading the borrower as to the payment date or the consequences of default—the lender may rely on the strict terms of the contract to invoke acceleration and foreclose upon default, however harsh the consequences.²⁶ The Restatement explains: “This approach avoids difficult and time-consuming judicial inquiries into such matters as [the] degree of the mortgagor’s negligence, the relative hardship that acceleration imposes, and other subjective concerns.”²⁷ In contrast, some courts apply equity more expansively to relieve a borrower from the particularly harsh consequences of default, even default caused by the borrower’s own negligence or mistake, or the mistake of some third party aside from the lender.²⁸

Once the foreclosure sale is held, equity has at least two potential roles in policing the fairness of the sale price. As a generally accepted principle, although courts will not overturn an otherwise properly conducted foreclosure sale for an inadequate price alone, equity will intervene when the sale price is so low that the price is “grossly inadequate,” or, in the

²⁴ RESTATEMENT (THIRD) OF PROP.: MORTGS. § 8:1(d)(3).

²⁵ *Id.* § 8:1 cmt. e.

²⁶ *See id.*

²⁷ *Id.*

²⁸ *See, e.g., Vonk v. Dunn*, 775 P.2d 1088, 1092–93 (Ariz. 1989) (en banc) (finding error for the trial court to grant summary judgment foreclosing a mortgage when circumstances existed that a factfinder might find unconscionable—the borrowers’ default involved a missed payment due to a wrongful dishonor of the borrowers’ check by their bank (which was nothing of the mortgagee’s doing) as well as a separate default for nonpayment of \$66 of real estate taxes that could be found trivial on remand, notwithstanding that the borrowers evidently offered no excuse for its nonpayment).

Before the foreclosure sale, equity has an additional role in protecting the lender’s interest, further illustrating the origins of equity to safeguard the rights of both parties. A receivership to preserve the mortgaged property and collect property rents had origins in the English chancery court. Today, as recognized in the Restatement, many jurisdictions authorize appointment of post-default property receivers by statute or court rule. *See* RESTATEMENT (THIRD) OF PROP.: MORTGS. § 4.3 reporter’s note. Moreover, most loan documents customarily authorize appointment of a receiver, in which event the Restatement supports appointment upon default. *See id.* § 4.3(b). In the absence of such authorization, the Restatement approves the appointment of a property receiver upon default when, in accordance with the common law standard, the value of the property is inadequate to satisfy the debt and the mortgagor is committing waste—for example, the collection and retention of rents that the mortgagor should have paid to the mortgagee. *See id.* § 4.6(a)(5).

language of some judicial opinions, the court's conscience is shocked.²⁹ Although courts tend to disdain any precise formula for gross inadequacy or a shocked conscience, the Restatement suggests that ordinarily a court is only warranted in invalidating a foreclosure sale that fails to produce at least 20% of the property's fair market value.³⁰ In contrast to the short-lived attack in bankruptcy on regularly conducted foreclosure sales that failed to bring at least 70% of fair market value, and thus invalidated by some courts as a statutory fraudulent transfer,³¹ the standard in equity of sale invalidation for gross inadequacy seems rather nonthreatening to the mortgagee or any third party bidder.

A more disturbing application of equity from the vantage point of lenders is those courts that, in the absence of a statutory directive, invoke equity to credit borrowers in a deficiency proceeding with the fair market value of the property sold, despite a lower foreclosure sale price. Several states by statute protect the borrower from an undue deficiency judgment after the foreclosure sale by calculating the shortfall as the difference between the indebtedness and the greater of the foreclosure price or the property's judicially determined fair market value at the date of the foreclosure sale.³² In the absence of a statute, some courts have invoked their equitable jurisdiction in foreclosure to encompass the deficiency action, and adopted a judicially created fair market value standard to protect the borrower (and perhaps guarantors). For example, the Supreme Court of

²⁹ *Id.* § 8.3 reporter's note. A few courts, however, refuse to overturn a sale based on inadequacy of price, no matter how great, absent some sale misconduct or irregularity. *See, e.g., Holt v. Citizens Cent. Bank*, 688 S.W.2d 414, 416 (Tenn. 1984).

³⁰ *See* RESTATEMENT (THIRD) OF PROP.: MORTGS. § 8.3 cmt. b. Even if courts in equity do not see the sale price as grossly inadequate, they may invalidate a sale that is defective or irregular under local law prescribing appropriate foreclosure procedure, such as a sale held at an improper time or place. *Id.* § 8.3 cmt. c; *see also* Molly F. Jacobson-Greany, *Setting Aside Nonjudicial Foreclosure Sales: Extending the Rule to Cover Both Intrinsic and Extrinsic Fraud or Unfairness*, 23 EMORY BANKR. DEV. J. 139, 154 (2006) ("[a]ctions to set aside a nonjudicial foreclosure sale are equitable in nature," noting that a similar equitable standard governs judicial foreclosures).

³¹ *See, e.g., Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201, 203 (5th Cir. 1980), *abrogated by BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994). The Supreme Court ultimately rejected this interpretation of the federal Bankruptcy Code, ruling that a sale conducted in accordance with state law conclusively avoids invalidation as a fraudulent transfer. *See BFP*, 511 U.S. at 542 (1994) (noting that courts can nonetheless analyze sales for their receipt of reasonably equivalent value if not held in compliance with state law procedures, and that sales can otherwise be struck down under state foreclosure law (equity), rather than fraudulent transfer law, if the sale price is so low that it shocks the conscience).

³² *See* MADISON, DWYER & BENDER, *supra* note 17, § 12:73.

Montana deployed equity to avoid a “catastrophic deficiency judgment” against the borrowers when the loan balance exceeded \$1.5 million, and the foreclosure sale price was only \$565,000 despite the property’s fair market value (later determined as \$1.1 million) substantially exceeding that bid amount.³³ For those courts applying an equitable fair market value standard, the possibility exists, in theory, that a sale price of even a dollar less than fair value would be scrapped in favor of the dollar-greater fair market value. In contrast, other courts have concluded that equitable powers attendant to foreclosure do not justify imposing a judicial fair market value standard for calculating a deficiency judgment.³⁴

³³ Trs. of the Wash.-Idaho-Mont. Carpenters-Emp’rs Ret. Trust Fund v. Galleria P’ship, 780 P.2d 608, 616 (Mont. 1989) (affirming the trial judge’s discretion to average the expert testimony on value to arrive at \$1.1 million, thus reducing the borrowers’ deficiency liability by \$535,000 in relation to the foreclosure sale price of \$565,000); *accord* Citibank, N.A. v. Errico, 597 A.2d 1091, 1097 (N.J. App. Div. 1991); RESTATEMENT (THIRD) OF PROP.: MORTGS. § 8.4.

Equity has also intervened to eliminate interest running on a deficiency judgment when a mortgagee has unnecessarily delayed obtaining a deficiency. *See* MTGLQ Investors, L.P. v. Egziabher, 39 A.3d 796, 798 (Conn. App. Ct. 2012) (sanctioning a mortgagee in equity by denying 180 days of interest for inordinate delay between date of initiating action and obtaining deficiency judgment).

³⁴ *See, e.g.,* Illini Fed. Savs. & Loan Ass’n. v. Doering, 516 N.E.2d 609, 612–13 (Ill. App. Ct. 1987); First Bank v. Fischer & Frichtel, Inc., 364 S.W.3d 216, 219–20 (Mo. 2012) (en banc). In *Fischer & Frichtel*, the Missouri Supreme Court incorrectly stated that no jurisdictions have rejected the foreclosure sale price approach to follow the fair market value standard sourced in the common law. *See Fischer & Frichtel*, 364 S.W.3d at 223. Inexplicably, the court cites Montana’s *Galleria* decision as an example of a state that has always applied a fair market value standard. For the sake of argument, even had Montana long followed this approach, which is not accurate, that fair market value approach was nonetheless grounded in equity and not state statutes. *Contra id.* at 222. The Missouri Supreme Court, or its judicial clerk, was simply asleep at the switch.

To some extent, a clear statutory imperative, requiring a calculation of a deficiency by reference to the foreclosure price rather than a greater fair market value, might tie an equity court’s hands. Nevertheless, the Montana Supreme Court in the *Galleria* litigation rejected a dissenting justice’s argument that the Montana legislature had dictated that outcome by specifying deficiencies are owing for the balance remaining due after the foreclosure sale proceeds are accounted for. *See Galleria*, 780 P.2d at 619–20 (McDonough, J., dissenting). Presumably, the majority believed that the statute was silent on the question of the court’s equitable authority to impose a fair market value standard. Had the statute explicitly addressed and rejected the court’s fair market value jurisdiction, the court’s equitable authority would give way to the legislature. *See Krohn v. Sweetheart Props., Ltd. (In re Krohn)*, 52 P.3d 774, 782 (Ariz. 2002) (stating that although the legislature could deprive the courts of equitable power to supervise inequities in foreclosure sale price, it had not done so).

IV. EQUITY IN TIMES OF MORTGAGE CRISIS

To examine the operation and evolution, if any, of equity during times of mortgage crisis, this Article focuses below on three time periods of economic upheaval affecting housing: the Great Depression of the early 1930s, the savings and loan crisis of the late 1980s and early 1990s, and the subprime mortgage crisis and accompanying Great Recession occurring roughly between 2007 and 2012.³⁵ In all three time periods, real estate values collapsed dramatically, resulting in millions of U.S. homes valued at less than the mortgage balance (underwater). Moreover, particularly during the Great Depression and the subprime mortgage crisis, massive job loss imperiled the ability of borrowers to afford their mortgage loan payments. In these economic circumstances, borrowers likely desired, among other things: (1) additional time in the foreclosure process to seek employment and bring the loan current or refinance; (2) a right to reinstate (deaccelerate) the loan; (3) a reduction in the principal loan balance to the property's fair market value; and (4) protection from a deficiency judgment in the event of any foreclosure sale. The judicial equity experience in times of economic crisis, however, generally failed to accord much, if any, protection to mortgage borrowers.

A. The Great Depression

Real estate values collapsed during the Great Depression as unemployment mounted and mortgage lending sources dried up. Comparing the even greater plummet of value during the subprime mortgage crisis, the *Wall Street Journal* recounted that housing prices declined 31% during the Great Depression.³⁶ Foreclosures were commonplace—an estimated half of U.S. urban home mortgages were in default as of January 1934.³⁷ An absence of competitive bidding at foreclosure sales³⁸ combined with the prospect of a

³⁵ Of course, other foreclosure and economic crises have occurred, both local and national in scope. See, e.g., *Aames Funding Corp. v. Dudley*, No. 2978/106, 2009 WL 4282857, at *1 (N.Y. Sup. Ct. Nov. 30, 2009) (mentioning the foreclosure crisis of the mid-1970s during the economic recession).

³⁶ See Mark Gongloff, *Housing Shocker: Home Prices Still Falling*, WALL ST. J. (May 31, 2011), <http://blogs.wsj.com/marketbeat/2011/05/31/housing-shocker-home-prices-still-falling/>.

³⁷ See David C. Wheelock, *Changing the Rules: State Mortgage Foreclosure Moratoria During the Great Depression*, 90 FED. RES. BANK OF ST. LOUIS REV. 569, 569 (2008), available at research.stlouisfed.org/publications/review/08/11/Wheelock.pdf.

³⁸ See CABELL PHILLIPS, FROM THE CRASH TO THE BLITZ, 1929-1939, 2-3 (Fordham Univ. Press 2000) (1969) (telling a Great Depression era story of how a mob of local residents ensured a fair bid by the mortgagee).

substantial deficiency judgment following the lender's credit bid, led some borrowers to urge courts to impose an equitable judicial moratorium and thereby delay the mortgage foreclosure sale, presumably until the property market stabilized.³⁹ Generally, the courts rejected these pleas. Consistent with the strict traditional view discussed above⁴⁰ under which equity courts refuse to intervene to deaccelerate the loan unless the lender engaged in fraud, bad faith, or other unconscionable conduct, lenders could argue they played no role in the external economic factors that prompted the Great Depression, thereby avoiding equitable intervention.⁴¹ Overall, lenders successfully portrayed their financial suffering as equivalent to the woes of mortgage borrowers, and courts tended not to deviate from established foreclosure protocol. The North Carolina Supreme Court took this strict stance in rejecting the borrowers' efforts to prevent a 1931 foreclosure sale.⁴² The borrowers complained that "there was a condition of depression throughout the entire country in finance and real estate, and . . . that on account of the scarcity of money and poor market conditions, it was impossible to obtain the fair market value of lands at a judicial foreclosure"⁴³ Framing the question before it as, "[d]oes the depression or unprecedented scarcity of money for ordinary transactions or enforced stagnation of the real estate market constitute an equity sufficient to warrant a court in restraining the exercise of the power of sale in a deed of trust?" the court observed that ordinarily equitable relief must be based on allegations of lender fraud, oppression, or unconscionable advantage.⁴⁴

³⁹ Until the U.S. government subsidized mortgage lending through the Federal Housing Administration beginning in 1934, mortgage loans tended to be short-term with large balloon payments. See discussion *supra* note 10. Today 15 and 30-year fully amortized mortgage loans are the norm. Given the unavailability of mortgage credit during the Great Depression, maturity of the short-term mortgage loan effectively meant that the mortgagor faced foreclosure, supplying an additional impetus toward arguments for equitable relief.

⁴⁰ See *supra* Part III.

⁴¹ In contrast, many commentators have blamed loan originators and others in the securitization chain for the subprime loan debacle. See, e.g., Peter Hawkes, *Reaching the Bottom of the Barrel: How the Securitization of Subprime Mortgages Ultimately Backfired*, 24 REAL EST. FIN. J. 55, 57 (2008), available at www.lanepowell.com/wp-content/uploads/2009/04/hawkesp-001.pdf.

⁴² See *Bolich v. Prudential Ins. Co. of Am.*, 164 S.E. 335, 336–37 (N.C. 1932).

⁴³ *Id.* at 336 (internal quotation marks omitted).

⁴⁴ *Id.*; see also *Metropolitan Life Ins. Co. v. Rasberry*, 168 S.E. 669, 670 (N.C. 1933) (expressing sympathy for borrowers in foreclosure during the Great Depression, but ordering their ejection from possession after the foreclosure sale). Additionally, the *Metropolitan Life* court noted that it might have decided differently had the borrowers been able to pay any of the accrued real estate taxes and interest on the debt; however, the trial judge had refused

Denying the borrowers' plea, the court concluded that "mere allegations" of financial depression are inadequate to invoke equity's power to restrain a foreclosure sale.⁴⁵ A New York appellate court in 1933 similarly disagreed that holding a foreclosure sale during the Great Depression was unconscionable, concluding it was the court's duty, in the absence of inequitable conduct by the mortgagee, to enforce the mortgage.⁴⁶ Another 1933 New York opinion rejected a borrower's purported foreclosure defense, alleging an "abnormal world-wide and unprecedented cataclysm and disastrous depression . . . so that there is stagnation in the real estate mortgage and lending markets and an absolute failure of . . . such markets[,]" making it impossible to refinance the mortgage loan.⁴⁷ Among the relevant factors in denying equitable relief was the borrower's status as a real estate company, leading the court to pose the question:

How can any court say that defendant, who has borrowed money on property and spent it extravagantly or invested it unwisely, is entitled to any more sympathy than the man who has, after a lifetime of hardship and thrift, accumulated money which he lends at a reasonable rate of interest?⁴⁸

to restrain the sale based on the argument that the Great Depression made the borrowers' ability to raise sufficient funds to satisfy their debt impossible. See *Metropolitan Life*, 168 S.E. at 670.

⁴⁵ *Bolich*, 164 S.E. at 336.

⁴⁶ See *Strochak v. Glass Paper Making Supplies Co.*, 267 N.Y.S. 282, 283 (N.Y. App. Div. 1933); cf. *S. Grocery Co. v. Merchs.' & Planters' Title & Inv. Co.*, 54 S.W.2d 980, 981 (Ark. 1932) (holding that the lower court did not abuse its discretion in rejecting objections that the court should have postponed a sale during the Great Depression until normal conditions and values were restored, despite the foreclosure sale bringing less than half of "normal value"). The *S. Grocery* court concluded that no allegation of fraud or inequitable conduct relating to the sale existed, aside from the allegation that it did not bring a sufficient price. See *S. Grocery*, 54 S.W.2d at 981. Despite the general rule, the court concluded that mere inadequacy of sale price, however gross, was not a basis for setting aside the foreclosure sale absent fraud or other inequitable conduct. Compare *id.*, with RESTATEMENT (THIRD) OF PROP.: MORTGS. § 8.3 reporter's note (1997) (stating that equity will intervene when the sale price is so low that the price is "grossly inadequate").

⁴⁷ *Loma Holding Corp. v. Cripple Bush Realty Corp.*, 265 N.Y.S. 125, 126 (N.Y. Sup. Ct. 1933).

⁴⁸ *Id.* at 131 (holding that although the lender was seeking a judgment on the obligation rather than a foreclosure of its mortgage, the mortgagor's equity of redemption presumably was implicated by the mortgage remaining on the collateral); see also *Morris v. Waite*, 160 So. 516, 518 (Fla. 1935) (denying equitable moratorium of foreclosure, reasoning that the prevailing economic woes—the Great Depression—operate on the mortgagor and mortgagee alike); *First Union Trust & Savs. Bank v. Div. State Bank*, 272 Ill. App. 487, 492–93 (1933) (holding that

In the eyes of equity, the Great Depression devastated the expectations of borrowers and lenders equally and neither was to blame nor be rescued.

Courts applying equity tended to strictly enforce the lender's contractual expectations despite the crisis. South Dakota's Supreme Court in 1935 refused to "disregard the terms of the contract" and grant a delay in the foreclosure sale, reasoning that a moratorium was beyond the court's equitable powers and would amount to a taking of the lender's property rights without compensation.⁴⁹ Additionally, in a 1932 decision, the Texas Court of Civil Appeals dissolved an injunction issued by the trial court enjoining the foreclosure sale of 5,314 acres of farmland.⁵⁰ The trial judge relied on the financial depression and the allegation that if the sale was delayed until the crop harvest, the debt would be satisfied.⁵¹ The appellate court, however, found no basis to postpone a proper sale of a valid lien until "times are better and the sale price of the security is enhanced to normal levels . . ."⁵²

These Great Depression era decisions denying an equitable right of postponement mirrored the outcome of similar judicial challenges raised by borrowers in prior times of economic distress. For example, the Nebraska Supreme Court held in 1894 that despite the prevailing business depression in 1893:

[W]e cannot see how the courts can interpose upon such grounds for the protection of unfortunate debtors. The mortgagees had a legal right to proceed, and the courts could not stay their hand, or refuse them process, merely because of circumstances of misfortune or hardship. Appeals for relief upon such grounds must be addressed to the conscience and mercy of creditors, and are wholly beyond the jurisdiction of judicial tribunals.⁵³

the lower court lacked authority to declare a moratorium as the mortgagee suffered the same degree as the mortgagor who let the property deteriorate and fall into disrepair).

⁴⁹ *Equitable Life Assur. Soc. of the U.S. v. Lickness*, 262 N.W. 206, 207–08 (S.D. 1935).

⁵⁰ *See Commonwealth Bank & Trust Co. v. MacDonell*, 49 S.W.2d 525, 527 (Tex. Civ. App. 1932).

⁵¹ *See id.* at 526.

⁵² *Id.*

⁵³ *Neb. Loan & Trust Co. v. Hamer*, 58 N.W. 695, 697–98 (Neb. 1894), *overruled on other grounds by* *Commercial Fed. Savs. & Loan Ass'n v. ABA Corp.*, 431 N.W.2d 613 (1988); *see also* *Lipscomb v. N.Y. Life Ins. Co.*, 39 S.W. 465, 466 (Mo. 1897) (refusing to void sale, despite a foreclosure sale taking place during time of "great monetary stringency" in 1893, explaining that "[h]owever strongly our sympathies may be enlisted for the unfortunate victim of hard times, they cannot furnish a basis for equity jurisdiction; and such

In contrast to these stingy applications of equity, a few courts during the Great Depression at least expressed willingness, if presented with facts more favorable to the borrower, to delay the foreclosure sale based on the financial crisis and the compelling equities of the particular borrower, suggesting equity might intervene in sympathetic enough circumstances.⁵⁴ Two New Jersey Chancery Court opinions from 1933 illustrate the potential use of equity to impose a foreclosure moratorium should the borrower offer compelling enough justification, which the borrowers in both cases failed to demonstrate. In *Fifth Avenue Bank of New York v. Compson*,⁵⁵ the court recognized that the "present financial emergency, world-wide in its scope and affecting all nations and peoples . . . may necessitate new applications of legal and equitable rules" to prevent injustice.⁵⁶ At the same time, that equitable power "should be sparingly used."⁵⁷ Relying on the prevailing Great Depression in which "[j]udicial sales in foreclosure cases are a mere formality, resulting almost invariably in the mortgaged premises being purchased by the complainant mortgagee for a nominal sum, leaving the defendant mortgagor liable to a deficiency judgment in an amount

courts cannot and ought not to be made the instruments of speculation in the future values of property, even for the benefit of the unfortunate"); *McGown v. Sandford*, 9 Paige Ch. 290, 291 (N.Y. Ch. 1841) (holding that the court of chancery has no ability to suspend collection of debts despite depressed property value); *Caperton v. Landcraft*, 3 W. Va. 540, 541 (1869) (finding an injunction of sale erroneous when based on prevalent depression and scarcity of money); *cf. Anderson v. White*, 2 App. D.C. 408, 417 (D.C. Cir. 1894) (rejecting a claim against a foreclosure sale held during the holiday season in excessive winter cold, stating that whether "times are hard" or "money scarce," or the "time of year" unpropitious, or that the property would likely sell for a great deal more at a later period, afford no ground for equitable relief").

⁵⁴ For example, a New York Supreme Court judge in 1933 contended that although in "ordinary circumstances, no tolerance would be given to a plea delaying the mortgagee's right to foreclose and sell," in the "unbelievable hours of darkness" of the Great Depression "the court should be unafraid and fearlessly be the first to modify established precedent and the rigor of the law in the cause of justice." *Bank of Manhattan Trust Co. v. Ellda Corp.*, 265 N.Y.S. 115, 124 (N.Y. Sup. Ct. 1933), *rev'd on other grounds*, 271 N.Y.S. 522 (App. Div. 1934).

To us it seems inconceivable for the court to blind its eyes and deafen its ears to the calamity now existing in the field of real estate investments. If equity can mold its remedies to meet conditions as they arise, then equity should not fail in this emergency to hold the scales even, and, if need be, wield the sword to defeat temporarily or destroy permanently un contemplated yet actual destruction because of established legal form and procedure.

Id.

⁵⁵ 166 A. 86 (N.J. Ch. 1933).

⁵⁶ *Id.* at 87.

⁵⁷ *Id.*

approximately equal to the original debt,” the borrower urged a delay of the foreclosure sale for at least 1 year “pending economic rehabilitation and recovery.”⁵⁸ Denying such equitable relief, the court pointed out the borrower’s lack of financial equity in the mortgaged premises—the debtor owed \$11,000 more than the \$32,000 purchase price 11 years prior.⁵⁹ As such:

Obviously no benefit can accrue to him from a delay of the sale at this time, as even should there be a substantial business recovery within the next year it is hardly possible that the market value of the property would increase sufficiently to pay the incumbrances against it, and the court should not become an instrument of speculation on future property values.⁶⁰

Similarly, in another decision the New Jersey Chancery Court denied a borrower’s request for an injunction to delay a Great Depression era foreclosure sale, which the court perceived as merely enabling the borrower to speculate on the future real estate market.⁶¹ Because the borrower’s investment in the property did not exceed \$17,400 (presumably representing the down payment), it paled in comparison to the lender’s investment of \$257,000.⁶² Moreover, the parties’ experts sharply conflicted in valuing the property, with the lender’s valuation at less than the loan balance and the court believing in the context of the prevailing Great Depression that no method to determine value supplied reasonable definiteness.⁶³

A separate opportunity to apply judicial equity in the context of an economic downturn exists in the lender’s pursuit of a deficiency judgment, particularly when the lender is the successful bidder at its foreclosure sale. Notably, in a 1933 decision, the Wisconsin Supreme Court approved the intervention of a court sitting in equity to protect the borrower when

⁵⁸ *Id.* at 86–87.

⁵⁹ *See id.* at 86.

⁶⁰ *Id.* at 87.

⁶¹ *See* Kotler v. John Hancock Mut. Life Ins. Co., 168 A. 36, 37 (N.J. Ch. 1933) (seeking an injunction from the sale “until the present economic conditions have passed to the extent where there will be an active market for real estate and an opportunity for the complainant to either sell her equity in the property at a profit or obtain a [refinance] mortgage”).

⁶² *See id.* at 36.

⁶³ *See id.* at 37.

economic depression stymies competitive bidding at the foreclosure sale.⁶⁴ In these circumstances, the court ruled it can fix a minimum price (upset price) that the property must bring at the foreclosure sale in order for the court to approve (confirm) the sale.⁶⁵ Alternatively, the court can conduct a hearing to establish the fair market value of the mortgaged property and credit that amount against the debt for purposes of any deficiency judgment.⁶⁶ In the facts before the court, the lender bid \$600 at the foreclosure sale and sought a \$1,379 deficiency.⁶⁷ Because the trial court determined the premises were worth over \$2,000, it denied a deficiency.⁶⁸ Although recognizing the equitable authority of the trial court, the Wisconsin Supreme Court reversed and remanded to allow the mortgagee the option of accepting the fair market value credit or, should it reject that credit, facing the prospect of a resale with a fixed upset price.⁶⁹ Presumably, given the absence of competitive bidding, the lender would opt to forego a resale, and thereby retain the mortgaged property, yet be denied any deficiency.⁷⁰

⁶⁴ See *Suring State Bank v. Giese*, 246 N.W. 556, 558 (Wis. 1933).

⁶⁵ See *id.* at 557.

⁶⁶ See *id.* at 558.

⁶⁷ See *id.* at 557.

⁶⁸ See *id.*

⁶⁹ See *id.* at 558.

⁷⁰ See *id.* In 1935, the Wisconsin legislature enacted a statutory credit of fair market value for purposes of calculating the mortgage loan deficiency. See WIS. STAT. ANN. § 846.165(2) (West 2013):

In case the mortgaged premises sell for less than the amount due and to become due on the mortgage debt and costs of sale, there shall be no presumption that such premises sold for their fair value and no sale shall be confirmed and judgment for deficiency rendered, until the court is satisfied that the fair value of the premises sold has been credited on the mortgage debt, interest and costs.

Id. In a 1933 New Jersey Chancery Court decision, the lender foreclosed on a debt exceeding \$10,000, acquiring the property worth several thousand dollars for a credit bid of only \$100. See *Baader v. Mascelino*, 166 A. 466, 466 (N.J. Ch. 1933). The lender pursued a deficiency judgment, prompting the debtor to fraudulently convey his assets to hide them from the deficiency recovery. See *id.* Citing the prevailing Great Depression, the court held the lender could not set aside the fraudulent conveyances without first surrendering the profit from the lender's purchase of the mortgaged property for only \$100. See *id.* at 467. Toward that end, the court valued the mortgaged property at \$3000, and gave the borrower an additional \$2900 credit (\$3000 less the \$100 credit bid) against the deficiency judgment. See *id.* at 468; see also *Fed. Title & Mortg. Guar. Co. v. Lowenstein*, 166 A. 538, 542 (N.J. Ch. 1933) (requiring a mortgagee to accept collateral at fair market value for purposes of deficiency was not an injustice).

Overall, equity made no great strides of borrower protection during the Great Depression. Most courts were hesitant to upset contractual expectations, particularly if lenders seemed to be suffering equally with borrowers. Apart from the Wisconsin Supreme Court in the context of a deficiency proceeding, mortgagees could expect to rely on their contractual and statutory rights to foreclose and recover on the mortgage note so long as they did not affirmatively engage in any unconscionable behavior.

B. The Savings and Loan Crisis

The savings and loan crisis of the late 1980s and early 1990s witnessed the largest U.S. bank failure since the Great Depression and another collapse in real estate values. With farms as the cornerstone of the Great Depression foreclosure experience and residential foreclosures at the core of the subprime crisis, the savings and loan crisis featured foreclosures of commercial properties. In fact, the shift from home loans to commercial lending by savings and loan associations, prompted by federal deregulation, helped to spark the collapse when imprudent loans were made.⁷¹ With the emphasis on commercial foreclosures, courts should have expected a considerable amount of litigation as once wealthy commercial borrowers and guarantors fought deficiency judgments or otherwise sought to recoup

In contrast to the Wisconsin decision, in 1936 the Oregon Supreme Court held that the court had no equitable power to fix an upset price in the foreclosure sale as the sheriff's sale was "controlled wholly by statute." *Cal. Joint Stock Land Bank of S.F. v. Gore*, 55 P.2d 1118, 1121 (Or. 1936); *see also Mich. Trust Co. v. Dutmers*, 252 N.W. 478, 479–80 (Mich. 1934) (setting an upset price in excess of the fair value of security was found arbitrary and inconsistent with principles of equity; the case was remanded to fix the minimum bid at no greater than fair market value); *Mich. Trust Co. v. Cody*, 249 N.W. 844, 846 (Mich. 1933) (upholding the lower court's refusal to confirm foreclosure sale and its order of resale, but striking down upset price on resale as improvident and "too severe a limitation upon the subsequent resale").

⁷¹ *See* Robert J. Laughlin, *Causes of the Savings and Loan Debacle*, 59 *FORDHAM L. REV.* 301, 315 (1991). Among the many causes behind the collapse of real estate during the savings and loan crisis was the disconnect between the high prevailing interest rates needed to attract savings deposits and the lower mortgage loan rates from past years locked into the investment portfolios of these lenders. *See id.* at S309–10. Another cause was the impact of the federal Tax Reform Act of 1986 that jeopardized the tax shelter of real estate investments by, among other things, limiting passive losses from real estate investments in which the taxpayer does not materially participate, and lengthening depreciation schedules by eliminating accelerated depreciation. *See generally BENDER ET AL.*, *supra* note 8, at ch. 13. These negative impacts fell primarily on commercial real estate investments. Although lenders other than savings and loans, such as life insurance companies, were imperiled during the crisis, this Article refers to the collapse of real estate values in this era as the savings and loan crisis to demarcate the popular name for the downturn.

their investment losses. Some greater hostility from courts in doling out equitable or other relief to borrowers on their speculative real estate investments might also have been expected. Overall, the savings and loan foreclosure experience confirmed these expectations. On the equity front, no significant retractions or expansions of equitable intervention in foreclosures accompanied that crisis.⁷² Rather, judicial hostility to borrower challenges was evident in the retrenchment of common law lender liability theories once commercial loan disputes from the savings and loan debacle reached the appellate courts.⁷³

As discussed in *Modern Real Estate Finance and Land Transfer*, lender liability is a "constellation of traditional theories of liability coupled with evolving rules applicable to a certain family of defendants," namely, lenders.⁷⁴ Originally limited to breach of express contract claims, lender liability lawsuits evolved to encompass claims cutting across the spectrum of common law contract and tort—such as negligence, breach of the implied contractual covenant of good faith, tortious interference, duress, and breach of fiduciary duty. During the crisis, borrowers particularly sought to invoke nebulous theories such as good faith, and to bring claims sounding in tort or contract that could give rise to punitive damage awards.

Of the borrowers' claims whose star fell the farthest in the throes of the savings and loan crisis, the good faith covenant⁷⁵ leads the pack. Sourced in

⁷² See *Trs. of the Wash.-Idaho-Mont. Carpenters-Employers Ret. Trust Fund v. Galleria P'ship*, 780 P.2d 608, 617 (Mont. 1989) ("Courts sitting in equity are empowered to determine all the questions involved in the case and to do complete justice; this includes the power to fashion an equitable result."). *Galleria* involved a 1987 foreclosure sale, followed by a deficiency action for more than \$1 million. See *id.* at 616. Although Montana statutes did not specify a fair market value formula for calculating the deficiency judgment, the court invoked its equitable jurisdiction to remand for a determination of fair market value in excess of the foreclosure price, resulting in a substantially smaller deficiency. See *id.* at 617; see also *Trs. of the Wash.-Idaho-Mont. Carpenters-Employers Ret. Trust Fund v. Galleria P'ship*, 819 P.2d 158, 165 (1991) (affirming the trial judge's discretion to average the expert testimony on value to arrive at \$1.1 million value, thus reducing the borrowers' deficiency liability by \$535,000).

⁷³ See A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 *FORDHAM L. REV.* 963, 966 (1993) ("Despite a number of well-publicized jury decisions, overall the reported cases decided in favor of the lender outnumber those in favor of the borrower by a margin of nearly three to one Lenders are and have been winning in the courts."). Overby suggested the possibility of concern over an institutionally burdensome litigation explosion as a possible explanation for the shift in judicial philosophy to favor lenders. See *id.* at 1016.

⁷⁴ BENDER ET AL., *supra* note 8, at 499.

⁷⁵ On the origins of the good faith covenant in equity courts, see James A. Webster, Comment, *A Pound of Flesh: The Oregon Supreme Court Virtually Eliminates the Duty to Perform and Enforce Contracts in Good Faith*, 75 *OR. L. REV.* 493, 499–501 (1996).

the common law of contracts and in the Uniform Commercial Code (UCC),⁷⁶ the zenith of the implied covenant of good faith arrived just before the crisis with the Sixth Circuit's 1985 decision in *K.M.C. Co. v. Irving Trust Co.*⁷⁷ The Sixth Circuit affirmed a \$7.5 million jury award for a lender's failure to supply notice before terminating its borrower's ability to obtain advances on a commercial line of credit, leading to the company's collapse.⁷⁸ Despite the note's demand provision allowing the lender to call the entire loan due at any time in its unfettered discretion, presumably allowing it to terminate further advances, the Sixth Circuit treated the demand feature as "a kind of acceleration clause" governed by good faith.⁷⁹

In the throes of the savings and loan crisis, Judge Easterbrook of the Seventh Circuit authored the definitive rejection of *K.M.C.* in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*.⁸⁰ In *Kham*, the lender relied on its express contractual right to cease funding future advances on a credit line upon five days' notice to the borrower.⁸¹ Characterizing good faith as "an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of the drafting, and which therefore was not resolved explicitly by the parties,"⁸² Judge Easterbrook denied the borrower's challenge to the termination of its credit line as bad faith, rendering moot the lender's actual motives in terminating the advances.⁸³ Judge Easterbrook explained that using good faith to add an "overlay of just cause" to the lender's exercise of explicit contractual rights reduces commercial certainty and breeds costly litigation.⁸⁴ Disapproving of *K.M.C.*, Judge Easterbrook remarked that to the extent that case "holds that a bank must loan more money or give more advance notice of termination than its contract requires, we respectfully disagree."⁸⁵

⁷⁶ See U.C.C. § 1-304 (2012) (applying a good faith standard to all contracts governed by the UCC, encompassing sales of goods and security agreements for personal property loans).

⁷⁷ 757 F.2d 752 (6th Cir. 1985) (applying New York law).

⁷⁸ See *id.* at 766.

⁷⁹ *Id.* at 760.

⁸⁰ 908 F.2d 1351 (7th Cir. 1990).

⁸¹ See *id.*

⁸² *Id.* at 1357.

⁸³ See *id.*

⁸⁴ *Id.*

⁸⁵ *Id.* at 1358. For criticism of this restrictive textualist approach, see Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1227 (1993) (arguing that the Easterbrook approach "misapprehends the role of good faith in contractual relationships").

Although neither *K.M.C.* nor *Kham* involved loans secured by real estate, other courts seized upon the *Kham* approach to supply the mortgagee refuge from bad faith if it could point to some contract provision that authorized its conduct, whether directly or indirectly.⁸⁶ Among them are the Oregon Supreme Court, which eviscerated the good faith covenant in a 1995 case arising out of the downturn in commercial real estate that accompanied the savings and loan crisis.⁸⁷ When an upscale Portland, Oregon apartment complex loan failed in 1991, the lender scheduled a nonjudicial foreclosure sale for December 20th of that year.⁸⁸ On October 22, the borrower notified the lender that it had received a desirable purchase offer that would result in proceeds exceeding the loan balance.⁸⁹ To enable the buyer to procure financing, however, required additional time and a postponement of the scheduled trustee's sale, which the lender was unwilling to grant.⁹⁰ The foreclosure sale took place as scheduled and the lender, having acquired the property by credit bid for the amount of its debt (\$7.8 million), promptly sold the complex to the same buyer for just the amount of its foreclosure bid, while the borrower received nothing.⁹¹ The borrower challenged the lender's refusal to postpone the sale as both a breach of the implied covenant of good faith and as an intentional interference with the failed purchase contract.⁹² Rejecting both claims, the Oregon Supreme Court framed the issue as whether the written loan contract authorized the lender to foreclose on the borrower's admitted default—put differently in the context of good faith, whether the delinquent borrower reasonably expected the lender's exercise of foreclosure.⁹³ This supposed contractual authorization also doomed the borrower's interference claim—a lender taking action (here, foreclosure) consistent with an “express contractual

⁸⁶ See, e.g., *Uptown Heights Assocs. Ltd. P'ship v. Seafirst Corp.*, 891 P.2d 639, 647–48 (Or. 1995).

⁸⁷ See *id.* at 642–43.

⁸⁸ See *id.* at 642.

⁸⁹ See *id.*

⁹⁰ See *id.*

⁹¹ See *id.*

⁹² See *id.* at 642–43.

⁹³ See *id.* at 647–48; see also *In re Porter*, 890 P.2d 1377, 1388 (Or. 1995) (en banc) (Fadeley, J., concurring) (remarking that Oregon's Supreme Court had effectively “relegated the implied covenant of good faith . . . to some sort of legal museum for former remedies that are no longer used”). On the Oregon Supreme Court's emasculation of the good faith covenant, see generally Webster, *supra* note 75. See also Daniel C. Peterson, Comment, *All the King's Horses and All the King's Men: Are Oregon Courts Putting the Good Faith Obligation Back Together Again?*, 84 OR. L. REV. 907, 922–26 (2005).

remedy,” and thus reasonably expected, is acting with a “legitimate purpose” rather than an actionable improper one regardless of its motives.⁹⁴ Applying the standard of reasonable expectation, however, reveals how the Oregon court undercut the good faith (and intentional interference) standard. Surely, the court was correct in saying a borrower in default can anticipate the lender’s initiation and exercise of foreclosure. However, a borrower with a contract to sell the property for more than the loan indebtedness may reasonably expect that the lender would facilitate its equitable right of redemption through a payoff by postponing the scheduled foreclosure sale for a reasonable time to allow the voluntary sale to conclude, particularly in the case of a quick-hitting nonjudicial foreclosure sale. The rub was all in the framing—frame the issue broadly enough, and any conduct can be justified as reasonably expected under broad contractual dictates.⁹⁵

Reading the contract broadly in this manner allows virtually any lender-favorable conduct. For example, if the borrower in default can reasonably expect the lender to foreclose in accordance with state law, the borrower, presumably, could not complain about the lender’s unwillingness to participate in negotiations to restructure the distressed loan. With much of the applicable case law originating in the savings and loan crisis era, the courts agree that the mortgagee has no duty sourced in the good faith covenant to negotiate a workout agreement with its borrower,⁹⁶ nor to delay its initiation of collection remedies.⁹⁷

⁹⁴ *Uptown Heights*, 891 P.2d at 652.

⁹⁵ As the author explains to his students, had the *Uptown Heights* loan contract spoken specifically to the subject of borrower requests for postponement and provided that the lender could reject any requested postponement in its sole and absolute discretion, which the contract presumably did not, the borrower likely could not reasonably expect postponement in the circumstances of the case. Relatedly, see Van Alstine, *supra* note 85, at 1295–98. Van Alstine argued that, properly applied, the good faith covenant requires some “attention-calling” in the contract and a sufficiently informed agreement before the court should find displacement of external standards of reasonable conduct. *Id.* Even acknowledging that the implied contractual covenant of good faith is a gap filler, the framing of the issue is critical in ascertaining whether some “gap” exists. Evidently, a glaring gap remained in the *Uptown Heights* contract, yet the issue framed broadly as whether the contract authorized foreclosure upon default obscured that gap.

⁹⁶ See *Carter’s Court Assocs. v. Metro. Fed. Savs. & Loan Assn.*, 844 F. Supp. 1205, 1210 (M.D. Tenn. 1994) (“In the absence of an express contract term, there is no duty on the part of a lender to negotiate a workout or provide increased credit.”); *Travelers Ins. Co. v. Corporex Props., Inc.*, 798 F. Supp. 423, 424–25 (E.D. Ky. 1992); *Mont. Bank of Circle, N.A. v. Ralph Meyers & Son, Inc.*, 769 P.2d 1208, 1214 (Mont. 1989) (affirming summary judgment to a lender on a guarantor’s claim that the lender acted in bad faith by failing to

To the extent that good faith claims have remaining viability, case law arising during the savings and loan crisis firmly rejected borrower efforts to recover for lender bad faith in tort, thereby restricting relief for bad faith to contractual remedies that do not encompass punitive damages.⁹⁸ Relatedly, appellate decisions attendant to the savings and loan crisis helped rein in lender liabilities beyond contract invoking theories such as fiduciary duty and negligence. Representative of cases rejecting a recharacterization of the lender-borrower relationship as a fiduciary status is the South Dakota Supreme Court's 1990 decision in *Garrett v. BankWest, Inc.*⁹⁹ Denying the

renegotiate the defaulted loan); *Metro. Life Ins. Co. v. Ill., Inc.*, 646 N.E.2d 528, 534 (Ohio Ct. App. 1994) (obviating a borrower's claim that the lender breached the duty of good faith by engaging in protracted negotiations that led the borrower to anticipate a workout by correspondence, reflecting the lender's constant insistence that borrower cure or face legal action); *Gaul v. Olympia Fitness Ctr., Inc.*, 623 N.E.2d 1281, 1288 (Ohio Ct. App. 1993) (stating that the lender's decision to foreclose is an exercise of contractual rights and not bad faith); *Badgett v. Sec. State Bank*, 807 P.2d 356, 361-62 (Wash. 1991) (stating that the implied covenant of good faith did not obligate a lender to consider the borrowers' proposal that the lender accept lesser pay-off of farm loan based on net funds borrower would receive from federal dairy farm termination program). For a case in the same vein arising out of the post-September 11th slump in the farming economy that prompted many U.S. farm foreclosures and consequent lawsuits against lenders, see *Farm Credit Servs. of Am. v. Dougan*, 704 N.W.2d 24, 26 (S.D. 2005) (rejecting a farmer's claim that a lender's refusal to agree to requested seven-month extension of late installment payment where collateral value exceeded debt was bad faith).

⁹⁷ See *Glenfed Fin. Corp., Commercial Fin. Div. v. Penick Corp.*, 647 A.2d 852, 860-61 (N.J. App. Div. 1994); cf. *Metro. Life Ins. Co. v. Triskett Ill., Inc.*, 646 N.E.2d 528, 533 (Ohio Ct. App. 1994) (finding a bad faith claim untenable when a lender obtained ex parte appointment of a receiver, enforcing its contractual rights). But see *Duffield v. First Interstate Bank of Denver, N.A.*, 13 F.3d 1403, 1405-06 (10th Cir. 1993) (finding that a lender breached its good faith covenant by invoking remedy of assignment of oil and gas profits without providing notice to cure; court views the lender's decision to exercise default remedies as involving an exercise of discretion, thus rejecting the lender's argument that good faith does not attach to contract provisions that unambiguously define the rights of parties).

⁹⁸ See, e.g., *Mitsui Mfrs. Bank v. Superior Court*, 260 Cal. Rptr. 793, 797 (Cal. Ct. App. 1989) (dismissing a cause of action for tortious breach of good faith, limiting such claims to fiduciary-like relationships and finding that the lender-borrower relationship ordinarily is not a fiduciary or special one); *Black Canyon Racquetball Club v. Idaho First Natl. Bank*, 804 P.2d 900, 911 (Idaho 1991); see also *Ulrich v. Fed. Land Bank of St. Paul*, 480 N.W.2d 910, 911 (Mich. Ct. App. 1991) (holding that Michigan does not recognize independent tort action for the breach of the covenant of good faith); *Garrett v. BankWest, Inc.*, 459 N.W.2d 833, 843 (S.D. 1990) (existing remedies in contract law found adequate for bad faith); *Charles E. Brauer Co., Inc. v. NationsBank of Va., N.A.*, 466 S.E.2d 382, 385 (Va. 1996) (finding that a breach of implied duty of good faith under the UCC gives rise to a cause of action for breach of contract, not tort).

⁹⁹ 459 N.W.2d 833 (S.D. 1990).

borrower's argument that a cash flow agreement with the lender specifying use of expected farm revenues constituted day-to-day control sufficient to establish a fiduciary relationship, the court further found that there was no inequality or dependence on the lender's superior knowledge given the borrower's experience and education.¹⁰⁰ On the negligence ledger, several decisions dispensed with these tort claims at the duty stage; for example, one case held that a commercial lender owed no duty to the borrower to ensure that the space leases in a shopping center the borrower was purchasing were satisfactory.¹⁰¹

C. The Subprime Mortgage Crisis

During the U.S. housing boom around 2004 and 2005, home loan originations exploded, particularly for subprime borrowers with low credit scores. Subprime loans tended to carry higher interest rates,¹⁰² which appealed to investors in the securitization markets, feasting on securitized subprime loans. Given the ability to shift risk to subsequent purchasers of the loan, credit was plentiful as investor-demand fueled loan originations with little regard to the viability of repayment and consequent adherence to traditional underwriting standards. As the housing market became superheated when the availability of credit and home prices jumped, even borrowers with decent credit scores but marginal incomes (who might otherwise be denied qualification for high-priced home purchases) were offered nontraditional (exotic) loan products that proved disastrous. Financial products replacing traditional down payments supplied 100% or more of the purchase price, with a high-interest "piggyback" junior loan for

¹⁰⁰ See *id.* at 838–39. A substantial majority of courts agree with *Garrett* in treating the lender-borrower relationship as a nonfiduciary one absent special circumstances. See A. Barry Cappello & Frances E. Komoroske, *Fiduciary Relationships Between Lenders and Borrowers: Maintenance of the Status Quo*, 15 W. ST. U. L. REV. 579, 594 (1988); Cecil J. Hunt II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 769 (1994) (discussing *Garrett* and suggesting that "massive confusion" exists in the case law on just which special circumstances convert the loan relationship into a fiduciary one).

¹⁰¹ See *Yousef v. Trustbank Savs.*, 568 A.2d 1134, 1138 (Md. Ct. App. 1990); see also *Nymark v. Heart Fed. Savs. & Loan Assn.*, 283 Cal. Rptr. 53, 54 (Cal. Ct. App. 1991) (holding that the lender ordinarily owes no duty of care to borrower in appraising collateral for purposes of qualifying borrower for loan). Particularly in the commercial context, the author lends support to the cited cases on theories of fiduciary duty and negligence, as many of these claims were asserted during the savings and loan era as a stretch to recover investment losses from deep pocket lenders and rightfully failed when they reached the appellate courts.

¹⁰² See generally STEVEN W. BENDER, *TIERRA Y LIBERTAD: LAND, LIBERTY, AND LATINO HOUSING* 47 (2010).

funds in excess of the 80% senior loan.¹⁰³ Lenders qualified borrowers using teaser below-market interest rates that floated at higher variable rates once the initial teaser period expired.¹⁰⁴ “Flex” loan products offered borrowers the ability to select and adjust their ongoing monthly payment to pay less or no principal and even to forego a monthly (interest) payment altogether.¹⁰⁵ “No doc[umentation]” or stated income loans abandoned lender verification of borrower income in exchange for higher interest rates or fees.¹⁰⁶ By 2007, these varieties of exotic and subprime loans began failing at catastrophic rates, scaring off investors and thus dooming mortgage loan originators by eliminating the market for their securitized loans.¹⁰⁷ The perfect storm for the housing crisis resulted when the mortgage credit market tightened and even disappeared, teaser interest rates and other adjustable rate loans reset at higher levels, and the broadening economic crisis reached global proportions and sparked widespread unemployment that prevented otherwise willing borrowers from making loan payments.

Housing prices plummeted during the subprime mortgage crisis, falling even more than during the Great Depression when prices fell 31%.¹⁰⁸ By early 2012, as measured by the Case-Shiller index, housing prices had fallen 33.8% from their peak in the second-quarter of 2006.¹⁰⁹ Given the scope of the financial crisis, it imperiled even conventional (nonexotic) mortgage loans. Even with traditional down payments, and ignoring the potential transaction costs of resale (for example, a broker’s commission), most homes purchased during the housing boom soon fell way underwater. To that extent, the “subprime” crisis is a misnomer as it claimed victims across the credit spectrum as unemployment spiraled and the housing market crashed.

The subprime lending experience included a decided predatory racial bent, with the incidence of high-cost subprime lending rising in

¹⁰³ See BENDER ET AL., *supra* note 8, at 250–51.

¹⁰⁴ See generally Jo J. Carrillo, *Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages*, 5 BERK. BUS. L.J. 1, 6–14 (2008) (addressing exotic loans made in California).

¹⁰⁵ BENDER ET AL., *supra* note 8, at 251.

¹⁰⁶ See *id.*

¹⁰⁷ See *id.*

¹⁰⁸ See Gongloff, *supra* note 36.

¹⁰⁹ Steven Russolillo, *S & P/Case Shiller: Home Prices at Lowest Levels Since Housing Crisis Began*, WALL ST. J. (Feb. 28, 2012), <http://blogs.wsj.com/marketbeat/2012/02/28/spcase-shiller-home-prices-at-lowest-levels-since-housing-crisis-began/>.

neighborhoods of color.¹¹⁰ As an NAACP lawyer observed: “It’s almost as if subprime lenders put a circle around neighborhoods of color and [said], ‘This is where [we’re] going to do our thing.’”¹¹¹ Previously ignored by mainstream mortgage lenders, African American and Latino borrowers in segregated enclaves were pursued aggressively by subprime lenders and mortgage brokers who often took advantage of these borrowers’ lack of credit history, their desire to own homes, and sometimes, their language barriers.¹¹² In addition to supplying a new market for origination fee-hungry mortgage lenders, these borrowers agreed to pay higher interest rates that ensured demand among Wall Street investors. The disparity in subprime lending between Anglo borrowers and borrowers of color was enormous. For example, in 2006, 46.6% of Latinos and 53.7% of African Americans’ financing home purchases used subprime loans, while only 17.7% of Anglo borrowers used these products.¹¹³ Surely, “[d]iscrimination and predatory practices appear to be responsible for at least some of th[is] subprime gap.”¹¹⁴

Between 2007 and late 2012, the subprime mortgage crisis claimed almost 4 million U.S. homes through foreclosure, a staggering total.¹¹⁵ Distinct from the commercial property flavor that demarcated the savings and loan crisis, the subprime loan crisis fell hardest on residential borrowers.¹¹⁶ With the specter of residential borrowers victimized by predatory lending terms,¹¹⁷ ripe conditions existed for equity’s evolution in

¹¹⁰ See Manny Fernandez, *Racial Disparity Found Among New Yorkers with High-Rate Mortgages*, N.Y. TIMES, Oct. 15, 2007, at B1.

¹¹¹ *Id.*

¹¹² For a discussion of the contradiction between historical credit redlining by avoiding borrowers of color and the “reverse redlining” of subprime lending, see BENDER, *supra* note 102, at chs. 5, 14.

¹¹³ See *id.* at 50.

¹¹⁴ *Id.* (explaining how many subprime borrowers of color actually should have qualified for prime mortgage terms and suggesting that discrimination explains some of the disparity between borrowers of color and Anglo borrowers).

¹¹⁵ See Brennan, *supra* note 6 (discussing a second wave of forthcoming home foreclosures in backlogged states).

¹¹⁶ Although some of these borrowers occupied the mortgaged property as their principal residence, others borrowed on speculation, holding residential properties for investment income.

¹¹⁷ Admittedly, there is a good deal of disagreement on the root causes and blame for the subprime mortgage crisis, with candidates including mortgage brokers, mortgage loan originators, investors in securitization markets, Wall Street investment bankers and credit ratings agencies, appraisers, regulators, and the borrowers themselves. Although opinions widely differ on blame, some compelling arguments posit the possibility that many borrowers were victimized, and thus are well situated for the provision of equity.

foreclosure to safeguard these borrowers. With few exceptions, however, little action occurred on the equitable front during the subprime mortgage crisis. Rather, most successful foreclosure challenges and impediments were drawn from the incompatibility (or the ill attention paid to detail) between the realities of Wall Street securitization of home mortgages and the requisites of "Main Street" mortgage lending statutes and foreclosure procedures. Equity, effectively, took a back seat.

1. The Dangerous Intersection of Wall Street Securitization and Main Street Foreclosure Laws

The traditional model of U.S. home lending, as well represented by the savings and loan association of the mid-twentieth century, was a Main Street lending model in which the originator of the mortgage held that loan for its duration. Government-sponsored entities—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—initiated the modern securitization push by purchasing home loans from originators, pooling them, and selling fractional interests in the loan income to investors.¹¹⁸ In the early 2000s, mortgage lenders and the financial community began bypassing the strict guidelines required for these federally-related securitizations, such as minimum down payments and other loan qualification standards, and instead employed so-called private label securitizations of nonconforming and more risky loans.¹¹⁹ Whether accomplished through Fannie Mae, Freddie Mac, or through private-label securitizations, by the early 2000s a clear majority of U.S. home mortgage loans were destined for Wall Street—with \$1.9 trillion of the \$2.5 trillion of mortgage loan originations in 2006 securitized and resold to investors; about 25% of them constituted subprime loans.¹²⁰

Perhaps most emblematic of the shift from Main Street lending to Wall Street securitization was the creation of Mortgage Electronic Registration Systems, Inc. (MERS), an entity formed in the 1990s to ostensibly hold record title or the mortgagee's lien interest, as the lender's nominee.¹²¹ Instead of recording a transfer of each assignment of ownership of the mortgage (or deed of trust) in the local real estate records, which would command a recording fee for each transfer, MERS, as the designated

¹¹⁸ See generally Hawkes, *supra* note 41, at 57.

¹¹⁹ See *id.*

¹²⁰ See *id.*

¹²¹ See MADISON, DWYER & BENDER, *supra* note 17, § 12:35, at 12-64 (quoting MERSCORP, Inc. v. Romaine, 861 N.E.2d 81, 82 (N.Y. 2006)).

nominee, would document each assignment in its internal electronic records at a lesser cost.¹²² Moreover, by initiating foreclosure in the name of MERS, the real party in interest (lender) might escape any negative publicity from prosecuting the foreclosure.¹²³

Whether contemplating judicial or nonjudicial foreclosures, most state foreclosure laws were enacted when the Main Street model of lending dominated—if Wall Street securitizations were even existent at all. The judicial experience during the subprime mortgage crisis (the acid test of home loan securitizations) proved the incompatibility of Main Street laws and foreclosure procedures with Wall Street securitization protocol. This poor fit prompted at least three legal challenges to securitized loan foreclosures, depending on the wording of applicable state law and the rigidity of local courts: (1) attacks on the standing of MERS to initiate a foreclosure given its failure to hold any beneficial interest in the promissory note and the underlying mortgage or deed of trust; (2) the frequent inability of MERS, or any other person related to the foreclosure, to produce the original promissory note in connection with the foreclosure action; and (3) the failure to document (and to record in the realty records) the assignment of the mortgage or deed of trust to the real party in interest (lender) other than through an informal communication of assignment to the MERS database.

Construing their state statutes governing which parties qualify as the mortgagee or deed of trust beneficiary to initiate judicial or nonjudicial foreclosure, and sometimes requiring that party to hold a beneficial ownership interest in the underlying promissory note, some courts accordingly denied MERS standing to prosecute the foreclosure, or in the case of a deed of trust, to appoint a successor trustee to hold a nonjudicial sale.¹²⁴

¹²² See *id.* § 12.35, at 12-63.

¹²³ MERS ultimately barred lenders from initiating or prosecuting foreclosure in its name, and whether MERS ever contemplated such foreclosures is unclear. Rather, in the frenzy of subprime foreclosures, lenders and servicing agents may have simply taken opportunistic advantage of the absence of any membership rule barring such foreclosures in the name of the designee or nominee.

¹²⁴ See, e.g., *Niday v. GMAC Mortg., LLC*, 302 P.3d 444, 445 (Or. 2013) (holding that under Oregon deed of trust laws only the party who lent money, or its successor in interest or an authorized agent, can act as a trust deed beneficiary for purposes of a nonjudicial sale and appointing a successor trustee, not MERS absent a showing of authorized agency); *Bain v. Metro. Mortg. Grp., Inc.*, 285 P.3d 34, 41, 42 (Wash. 2012) (holding that MERS is not a lawful beneficiary under state deed of trust law because only holders of the underlying note have the power to appoint a successor trustee to proceed with nonjudicial foreclosure). *But see Larota-Florez v. Goldman Sachs Mortg. Co.*, 719 F. Supp. 2d 636, 639 (E.D. Va. 2010)

Relatedly, especially in the context of judicial foreclosures, many courts construed their foreclosure laws or Article 3 of their state's adoption of the UCC to require the party initiating and prosecuting the foreclosure (whether MERS or some assignee of the loan) to demonstrate physical possession of the original signed mortgage note.¹²⁵ Moreover, because Article 3 requires

(holding that an assignee from MERS that serviced a debt was entitled to appoint a successor trustee under a deed of trust with authority to foreclose; rejecting the argument that securitization bars foreclosure because it impermissibly splits ownership of note from deed of trust), *aff'd*, 441 F. App'x 202 (4th Cir. 2011); *Taylor v. Deutsche Bank Nat'l Trust Co.*, 44 So. 3d 618, 622–23 (Fla. Dist. Ct. App. 2010) (holding that because loan documents granted MERS standing to foreclose, a bank that received a written assignment from MERS had standing in foreclosure); *US Bank, N.A. v. Flynn*, 897 N.Y.S.2d 855, 859 (N.Y. Sup. Ct. 2010) (rejecting a mortgagor's challenge to an assignment by MERS to a lender initiating foreclosure; mortgagor contended that the assignment did not effect a valid transfer of the note because MERS never had an ownership interest in the note). *See also* *Eaton v. Fed. Nat'l Mortg. Ass'n*, 969 N.E.2d 1118, 1131 (Mass. 2012) (finding power of sale foreclosure invalid if foreclosing plaintiff received transfer of the mortgage (assigned from MERS) without an accompanying transfer of the mortgage note; the references in the Massachusetts statutory provisions, which authorize nonjudicial powers of sale by the "mortgagee," were intended by the legislature to refer to the mortgage note holder (or its authorized agent)).

¹²⁵ *See* MADISON, DWYER & BENDER, *supra* note 17, § 12:35, at 12-67 (discussing how MERS, while initially having failed to take possession of the note, eventually changed its rules of membership to require delivery of the original note, properly indorsed, before MERS would initiate foreclosure; given the onslaught of judicial challenges, MERS eventually ended its practice of allowing lenders to foreclose in its name); *e.g.*, *HSBC Bank USA, Nat. Ass'n v. Miller*, 889 N.Y.S.2d 430, 431 (N.Y. Sup. Ct. 2009) (finding that although a mortgage was assigned to MERS, the promissory note did not follow the mortgage, denying the lender standing to prosecute judicial foreclosure absent possession of promissory note indorsed to it); *Bank of N.Y. v. Silverberg*, 926 N.Y.S.2d 532, 538 (N.Y. App. Div. 2011) (holding that in absence of possession of the note, MERS was not a lawful holder or assignee and was therefore without authority to assign the power to foreclose to the Bank of New York, which initiated the foreclosure proceeding). New York law governing subprime high-cost loans requires the mortgage foreclosure complaint to allege the plaintiff "is the owner and holder of the subject mortgage and note, or has been delegated the authority to institute a mortgage foreclosure action by the owner and holder of the subject mortgage and note." N.Y. Real Prop. Acts. Law § 1302 (McKinney 2013); *see also* *Mortg. Elec. Registration Sys., Inc. v. Saunders*, 2 A.3d 289, 294 (Me. 2010) (holding that although MERS lacked standing to initiate judicial foreclosure action because there was no evidence it possessed the note, the lower court properly substituted Deutsche Bank for MERS and allowed foreclosure to continue; the appellate court rejected the argument that a substitution of parties could not cure a jurisdictional defect and that the bank was precluded as a non-party from filing a motion of substitution).

Particularly in the context of nonjudicial foreclosures, some courts have rejected the need for proof of physical possession of the note as a condition to foreclose. *See, e.g.*, *Pantoja v. Countrywide Home Loans, Inc.*, 640 F. Supp. 2d 1177, 1184 (N.D. Cal. 2009) (holding that as the designated nominee in the deed of trust, MERS had the right to conduct the foreclosure process in its name given California law that authorizes an agent for the

the promissory note to supply an indorsement to subsequent holders, problems with foreclosure standing for securitized loans arose when gaps existed in the indorsement chain.¹²⁶

Apart from standards of possession and ownership of the note is the potential requirement under state law that the foreclosing party constitute an assignee of the mortgage or the beneficial interest under the deed of trust. A notable decision of the Massachusetts Supreme Judicial Court construed that state's nonjudicial power of sale law, permitting foreclosure by the mortgagee or its assigns, to require proof of an assignment from the record holder of the mortgage before initiation of foreclosure.¹²⁷ Other courts construe state statutory requirements even more rigidly, with some insisting on recordation of an assignment of the mortgage or deed of trust before initiating foreclosure, and a complete chain of recorded assignments between the original mortgagee and the lender initiating foreclosure.¹²⁸

mortgagee or beneficiary, as well as an agent of the trustee, to record a notice of default or notice of sale). The *Pantoja* court was not concerned that neither MERS nor the beneficiary Countrywide held possession of the promissory note; rather, the court stated that California law does not require the production of the original note in connection with initiating a nonjudicial foreclosure. *See id.*; *see also* Diessner v. Mortg. Elec. Registration Sys., 618 F. Supp. 2d 1184, 1187–88 (D. Ariz. 2009) (rejecting an argument under UCC law of negotiable instruments that MERS cannot initiate nonjudicial foreclosure), *aff'd*, 384 Fed. Appx. 609 (9th Cir. 2010); *Hogan v. Wash. Mut. Bank, N.A.*, 277 P.3d 781, 784 (Ariz. 2012) (stating that requiring a beneficiary to prove ownership of note would conflict with the inexpensive nonjudicial foreclosure process that legislature intended); *Gomes v. Countrywide Home Loans, Inc.*, 121 Cal. Rptr. 3d 819, 826–27 (Cal. Ct. App. 2011) (refusing to impose a requirement that MERS demonstrate in court its entitlement to initiate a nonjudicial foreclosure as nothing in the statute establishing nonjudicial foreclosure suggests such a judicial proceeding is permitted); *cf.* *Mansour v. Cal-Western Reconveyance Corp.*, 618 F. Supp. 2d 1178, 1181 (D. Ariz. 2009) (rejecting a “show me the note” argument for purposes of nonjudicial foreclosure in Arizona).

¹²⁶ *See* U.C.C. §§ 3-201(b), 3-205 (revised 1990) (2013). Under the UCC, indorsements must accompany notes that constitute order paper, which is typically the case, rather than more precarious bearer notes. *See, e.g.,* *Verizzo v. Bank of N.Y.*, 28 So. 3d 976, 978 (Fla. Dist. Ct. App. 2010) (finding that an original lender indorsed a note to an assignee, but there was no subsequent indorsement to the foreclosing lender or to MERS (the nominee of the original lender) thereby raising issue of material fact of whether the foreclosing lender had standing to foreclose).

¹²⁷ *See* *U.S. Bank Nat'l Assoc. v. Ibanez*, 941 N.E.2d 40, 54–55 (Mass. 2011) (finding that the assignment is not required to be in recordable form although recognizing that recording is the better practice).

¹²⁸ *See* *McCoy v. BNC Mortg., Inc. (In re McCoy)*, 446 B.R. 453, 457–58 (Bankr. D. Or. 2011) (rejecting the sufficiency of MERS as nominee of record and assigning the beneficial interest under deed of trust to a successor lender before foreclosure because crucial recorded assignments in the chain of ownership were missing). Although the deed of trust in

Particularly for securitized loans, these requirements proved problematic as assignments often existed only as notations in the electronic records of MERS showing current loan ownership, which did not include any signature of the assignors in the chain.¹²⁹

During the subprime mortgage foreclosure crisis, these emerging strict requisites of foreclosure procedure sourced in state laws and court rules led to accusations that some unscrupulous result-oriented lenders, loan servicing agents, and law firms engaged in so-called robo-signing of foreclosure-related documents.¹³⁰ These misdeeds ranged from signing documents that improperly claimed personal knowledge of facts (for example, of the borrower's default) to outright fraudulent creation of documents or other misrepresentations of fact.¹³¹ For example, jurisdictions demanding production of the original note as a condition to foreclosure may accept an affidavit of lost note attesting to a diligent search for the missing note.¹³² A party might fraudulently represent that it conducted a diligent search without having undertaken that search, or perhaps relied on, without verifying, information from others that the search was undertaken.¹³³

McCoy declared MERS the beneficiary, albeit solely as a nominee, Oregon law regards beneficiaries as those for whose benefit the trust deed was given—as the judge put it, the original lender and its assigns. *See id.* MERS had purported to assign the beneficial interest to U.S. Bank before the trustee's sale was initiated, but under the judge's interpretation of Oregon law, crucial assignments of the beneficial interest were missing. *See id.* Presumably, the original lender (BNC Mortgage) needed to have assigned of record to Lehman Brothers Holdings, which in turn should have assigned to Structured Asset Securities Corp., which in turn should have assigned to U.S. Bank as trustee of a trust. Instead, MERS purported to assign directly to U.S. Bank as the successor beneficiary at the time of default. *But see* CAL. CIV. CODE § 2932.5 (West 2013), *construed in* *Calvo v. HSBC Bank USA, N.A.*, 130 Cal. Rptr. 3d 815, 818–19 (Cal. Ct. App. 2011) (finding that the statute required a recorded assignment for mortgages with a power of sale, not for deeds of trust; the court thereby allows nonjudicial foreclosure initiated by MERS as lender's authorized agent without recorded assignment in favor of current lender). For examples of such statutes requiring recorded assignments of the security instrument, see IDAHO CODE ANN. § 45-1505(1) (2003) (stating that a trustee may foreclose a deed by advertisement and sale if “the trust deed, any assignments of the trust deed by the trustee or the beneficiary and any appointment of a successor trustee are recorded in mortgage records in the counties in which the property described in the deed is situated”). *See also* WYO. STAT. ANN. § 34-4-103(a)(iii) (2013) (requiring as a requisite to foreclosure “that the mortgage containing the power of sale has been duly recorded; and if it has been assigned, that all assignments have been recorded”).

¹²⁹ *See, e.g., Verizzo*, 28 So. 3d at 978.

¹³⁰ *See generally* MADISON, DWYER & BENDER, *supra* note 17, § 16:20.

¹³¹ *See id.*

¹³² *See generally id.* § 12:35.

¹³³ *See id.*

Missing assignments in the chain of record of the mortgage or deed or trust, or indorsements of the promissory note, might be created fraudulently, particularly if the mortgage originator, or other vital entity in the broken chain, is uncooperative or defunct.¹³⁴

Despite the plethora of litigation attacking the legitimacy of foreclosures of securitized loans and the role and participation of MERS in mortgage loans and foreclosures, going forward, lenders can presumably adjust their protocols to ensure compliance with Main Street statutes. Assignees of the loan can insist on delivery of the promissory note from the assignor, with proper indorsement, as well as an assignment of the mortgage or beneficial interest under the deed of trust, in recordable form for those jurisdictions demanding recordation. Even the MERS system of avoiding the fees of recording assignments in public land records is not jeopardized going forward, as these assignments need only be kept ready and recorded as needed should the borrower default and foreclosure become necessary, which in a normal economy occurs for only a few loans. Moreover, the standing of MERS to foreclose is no longer an issue going forward (although the question lingers for loan servicing companies), as MERS ultimately responded to the onslaught of legal challenges by denying its member lenders the right to foreclose in MERS' name.¹³⁵ By the time of the next housing downturn, Wall Street securitization should have mostly adjusted to the strict statutory requisites of Main Street foreclosure laws that derailed (or at least delayed) so many foreclosures in the subprime loan crisis. That likelihood places particular onus on equitable authority to impose substantive and procedural limits on foreclosure during an economic crisis that, unlike the various and mostly technical and procedural impediments of Main Street statutes, are less subject to correction and avoidance by careful recordkeeping and documentation. With few exceptions, however, equity did not appear ready for a starring role in supplying relief to mortgage borrowers in distress.

2. *Judge Spinner's Equity Jurisprudence*

One judge in particular drew the most attention for his equity rulings. A conservative judge in New York on the Suffolk County Court, Jeffrey Arlen

¹³⁴ The missing mortgage note would be harder to recreate as it would bear the borrower's signature. In contrast, indorsements and unrecorded assignments would bear the practically untraceable and sometimes unintelligible signatures of representatives of lenders.

¹³⁵ See MADISON, DWYER & BENDER, *supra* note 17, § 12:35.

Spinner,¹³⁶ startled lenders with several decisions issued during the subprime foreclosure crisis that invoked equity and displayed surprising remedial bite. As Professor Leif Rubinstein, head of Suffolk County's Touro Law Center's mortgage foreclosure clinic, remarked:

The thing I'm teaching in my class is how [Judge Spinner] is taking the equity arguments and how he's using them in all of his decisions. The [New York] Court of Appeals acknowledged that [a New York trial court] is a court of equity as well as a court of law. There haven't been many decisions citing that.¹³⁷

In a notable trio of opinions issued in 2009 and 2010 at the height of the crisis, Judge Spinner deployed equity to police what he saw as egregious lender misconduct.¹³⁸ First, in *IndyMac Bank F.S.B. v. Yano-Horoski*, Judge Spinner chastised a lender that he concluded had participated in bad faith in a statutory settlement conference with a borrower afflicted with health issues.¹³⁹ Rejecting every proposal the borrower put forth, from a proposed short sale purchase using third-party financing, to a loan modification obligating family members of the borrower, and to a deed in lieu of foreclosure abandoning the residence, the lender made clear, according to Judge Spinner, that it had no good faith intention of resolving the default short of foreclosure.¹⁴⁰ Recognizing the "yawning abyss of a deep mortgage and housing crisis," Judge Spinner concluded the lender's conduct was "inequitable, unconscionable, vexatious and opprobrious."¹⁴¹ Applying equitable discretion, he deemed the mortgage note (with a total amount due

¹³⁶ See *2008 Voter Guides*, N.Y. STATE UNIFIED COURT SYS., <https://www.nycourt.system.com/Applications/JCEC/Bio2008.php?ID=396> (last visited Feb. 1, 2014) (self-identifying as a conservative and listing party membership).

¹³⁷ Fass, *supra* note 7.

¹³⁸ See *Emigrant Mortg. Co. v. Corcione*, 900 N.Y.S.2d 608, 614 (N.Y. Sup. Ct. 2010), *vacated*, Order on Motion, No. 2009-28917, 2010 WL 7014850 (N.Y. Sup. Ct. Oct. 14, 2010); *Wells Fargo v. Tyson*, 897 N.Y.S.2d 610, 615 (N.Y. Sup. Ct. 2010); *IndyMac Bank F.S.B. v. Yano-Horoski*, 890 N.Y.S.2d 313, 310–19 (N.Y. Sup. Ct. 2009), *rev'd*, 912 N.Y.S.2d 239 (N.Y. App. Div. 2010).

¹³⁹ See *IndyMac*, 890 N.Y.S.2d at 316–17. New York requires a mandatory judicial settlement conference for residential mortgage foreclosures. See MADISON, DWYER & BENDER, *supra* note 17, § 19:2.

¹⁴⁰ See *IndyMac*, 890 N.Y.S.2d at 315–17.

¹⁴¹ *Id.* at 319.

in excess of \$500,000 as claimed by the lender) cancelled and voided, and the mortgage discharged from the land records.¹⁴²

In a 2010 decision, *Emigrant Mortgage Co. v. Corcione*, a mortgagee drew Judge Spinner's ire by including provisions for a general release of claims and a waiver of the bankruptcy automatic stay¹⁴³ in a residential loan modification proposal brought to the statutory foreclosure settlement conference.¹⁴⁴ Finding inequitable conduct, Judge Spinner responded by barring the mortgagee from collecting almost 2 years of post-default interest on the mortgage note, and invoking rarely used equitable discretion to levy exemplary damages for egregious conduct.¹⁴⁵ He awarded the borrower \$100,000 in punitive damages.¹⁴⁶ Additionally in the 2010 decision of *Wells Fargo v. Tyson*, Judge Spinner punished a lender with \$150,000 in punitive damages for its premature lock-out of a residential borrower.¹⁴⁷ Unable to afford utilities after defaulting, the borrower moved out and notified the mortgagee of his winterization of the unheated home, in which most of the family belongings were left behind.¹⁴⁸ Without notifying the borrower, the lender's agent entered the property, changed the locks, and thereby barred the borrower from access.¹⁴⁹ Finding two unauthorized entries into the unabandoned dwelling, Judge Spinner deemed them a "willful and wanton" trespass, invoked principles of equity, and awarded punitive damages.¹⁵⁰

In short order, however, each of these three controversial decisions was undone. The appellate division reversed the *IndyMac* ruling, explaining:

Here, the severe sanction imposed by the Supreme Court of cancelling the mortgage and note was not

¹⁴² See *id.* at 317 (expressing incredulity over a lender's calculation of amounts owed under the mortgage note).

¹⁴³ See generally MADISON, DWYER & BENDER, *supra* note 17, §§ 13:6-13:10 (discussing automatic stays in the context of real estate foreclosures, including provisions purporting to waive its protection).

¹⁴⁴ See *Emigrant Mortg.*, 900 N.Y.S.2d at 611.

¹⁴⁵ See *id.* at 614.

¹⁴⁶ See *id.* ("The Court also determines that the imposition of exemplary damages upon Plaintiff is equitable, necessary and appropriate, both in light of Plaintiff's shockingly inequitable, bad faith conduct as well as to serve as an appropriate deterrent to any future outrageous, improper and wrongful activities.").

¹⁴⁷ See *Wells Fargo v. Tyson*, 897 N.Y.S.2d 610, 617 (N.Y. Sup. Ct. 2010), *rev'd*, 917 N.Y.S.2d 914 (N.Y. App. Div. 2011).

¹⁴⁸ See *id.* at 612.

¹⁴⁹ See *id.* at 613.

¹⁵⁰ *Id.* at 617.

authorized by any statute or rule . . . nor was plaintiff [mortgagee] given fair warning that such sanction was even under consideration The reasoning of the Supreme Court that its equitable powers included the authority to cancel the mortgage and note was erroneous, since there was no acceptable basis for relieving the homeowner of her contractual obligation to the bank . . . particularly after a judgment [of foreclosure and sale] had already been rendered in the plaintiff's favor.¹⁵¹

In the *Emigrant Mortgage* litigation, following an additional settlement conference in which the lender acted in good faith to reach a settlement that Judge Spinner deemed equitable, he vacated his earlier decision imposing sanctions.¹⁵² Finally, in the *Wells Fargo* litigation, the New York appellate division overturned Judge Spinner's award of punitive damages for trespass, holding Wells Fargo was "not a party to the action resulting in the judgment from which it appeals," and "had no notice of the action."¹⁵³

Nevertheless, apart from the apparent judicial constraints on entirely forgiving the mortgage debt,¹⁵⁴ denying recovery of (some) interest and imposing punitive damages (if otherwise available in the state) are possible sanctions for inequitable lender conduct in appropriate circumstances and in

¹⁵¹ *IndyMac Bank, F.S.B. v. Yano-Horoski*, 912 N.Y.S.2d 239, 240–41 (N.Y. App. Div. 2010). The appellate division incorrectly cites two decisions for the proposition that no basis existed to relieve the mortgagor of her contractual obligation to the bank. One of those decisions, *Levine v. Infidelity, Inc.*, 728 N.Y.S.2d 670, 671 (N.Y. App. Div. 2001), held that the mortgagee was justified in accelerating on default and enforcing the mortgage when the mortgagee did not act in bad faith or unconscionably—an application of the traditional rule of equity. See *supra* Part III (discussing the traditional rule of equity). However, the *IndyMac* case involved findings that the lender had indeed acted in bad faith. See 912 N.Y.S.2d at 240. The other decision cited, *First Nat'l Stores, Inc. v. Yellowstone Shopping Ctr., Inc.*, 290 N.Y.S.2d 721, 725 (N.Y. 1968), involved a commercial lease termination rather than a mortgage, although the court of appeals in that case did discuss that contractual obligations cannot be undermined by judicial sympathy. Accordingly, against the backdrop of an exercise of the landlord's contractual rights, the court refused to treat the lease termination as harsh and inequitable and therefore voidable. See *id.* at 725–26. Again, unlike the *IndyMac* case, the court found no evidence that the landlord had engaged in bad faith or inequitable conduct. See *id.* at 725.

¹⁵² See Order on Motion, *Emigrant Mortg. Co. v. Corcione*, No. 2009-28917, 2010 WL 7014850 (N.Y. Sup. Ct. Oct. 14, 2010).

¹⁵³ *Wells Fargo v. Tyson*, 917 N.Y.S.2d 914, 915 (N.Y. App. Div. 2011).

¹⁵⁴ Presumably, Judge Spinner might have found it inequitable to foreclose the mortgage, relegating the mortgagee to an action on the note and the status of a judgment lien creditor in pursuing the property.

the hands of judges so inclined.¹⁵⁵ Undeterred by the above appellate experience, in 2012 Judge Spinner invoked equity to deny Bank of America the right to collect any interest between the date of the borrowers' default and the date of his order, and also levied \$200,000 in punitive damages.¹⁵⁶ At the statutory settlement conference of the home mortgage debt, Bank of America's counsel represented that the securitized loan was subject to a pooling and servicing agreement (PSA) that flatly prohibited reducing the principal balance.¹⁵⁷ Judge Spinner demanded production of the PSA to see for himself, and in a later exchange with the lender's counsel and a bank representative demanded to be shown precisely where the PSA absolutely prohibited a principal reduction.¹⁵⁸ At best, counsel could only point to a provision requiring the loan investors to approve any recommendation by the loan servicer to reduce principal, which makes good sense.¹⁵⁹ Based on the potential misrepresentation to the court, Judge Spinner found "serious and substantial questions" of good faith, justifying a harsh equitable sanction:

This Court cannot, and will not, countenance a lack of good faith in the proceedings that are brought before it, especially where blatant and repeated misrepresentations of fact are advanced, neither will it permit equitable relief to lie in favor of one who so flagrantly demonstrates such obvious bad faith. . . . Through its repeated and persistent failure and

¹⁵⁵ The appellate division further constrained the equitable remedies for bad faith negotiation under New York law in 2013, finding it error to impose the terms of a trial modification proposal on the lender by specific performance as an equitable remedy for bad faith—that remedy clashes with the statute's intent to encourage a mutually agreeable resolution, since a court order transforming a temporary, trial arrangement into a permanent one is not a mutually agreeable solution. *See Wells Fargo Bank, N.A. v. Meyers*, 966 N.Y.S.2d 108, 116–17 (N.Y. App. Div. 2013).

¹⁵⁶ *See Bank of Am. v. Lucido*, No. 2009-03769, 2012 WL 1292732, at *7–8 (N.Y. Sup. Ct. Apr. 16, 2012); *see also* *BAC Home Loans Servicing v. Westervelt*, No. 2455/10, 2010 WL 4702276, at *4 (N.Y. Sup. Ct. Nov. 18, 2010) (sanctioning bad faith in a negotiating settlement with a mortgagor by imposing an equitable remedy denying interest).

¹⁵⁷ *See Lucido*, 2012 WL 1292732, at *2. At an earlier settlement conference, Judge Spinner had warned counsel that if he found a lack of good faith in the settlement proceedings he would consider financial sanctions. *See id.* Presumably, Judge Spinner took note of the decision in *IndyMac Bank, F.S.B. v. Yano-Horoski*, 912 N.Y.S.2d 239, 240 (N.Y. App. Div. 2010), in which the court pointed to a lack of fair warning of a possible financial sanction—the forgiveness of the entire principal balance.

¹⁵⁸ *See Lucido*, 2012 WL 1292732, at *3.

¹⁵⁹ *See id.* at *4.

refusal to comply with the lawful orders of the Court including those which directed production of documentation that was essential to address critical issues . . . it has repeatedly caused to be put forth material mis-statements of fact which appear to have been calculated to deceive the Court and has delayed these proceedings without good cause, thereby needlessly increasing the amount owing upon the mortgage debt, to say nothing of the needless waste of the Court's time and resources, as well as those of the Defendant [borrowers].¹⁶⁰

Additionally in 2012, a New York Supreme Court judge from a nearby county denied collection of interest from the date of default on a loan secured by Brooklyn property.¹⁶¹ Concluding the lender had refused in bad faith to approve a proposed short-sale at the mandatory settlement conference,¹⁶² the judge denied interest as justified by the lender's misconduct.¹⁶³ Applying equitable powers of the court, the judge recognized the above New York appellate authority denying equitable cancellation of the entire loan and mortgage, but maintained the judicial power to deny

¹⁶⁰ *Id.* at *6–7. In fact, counsel did not deliver the PSA as demanded for months, and only after “intense prodding” did counsel offer to supply “salient portions” rather than the full agreement. *Id.* Apparently, the lender never did supply the complete PSA with schedules.

Judge Spinner does not always reach for equity to sanction mortgagees. *See* HSBC Bank USA, N.A. v. Blum, No. 2006-25122, 2010 WL 2754430, at *2 (N.Y. Sup. Ct. June 10, 2010). In 2010, he refused to aid borrowers who remained in their residence after foreclosure, despite their claims of health issues, instead finding that the borrowers had impeded the lender to such an extent that they had unclean hands unworthy of equitable intervention to deny their ouster:

[T]he record is replete with ample proof that Defendants have lived in the home ‘rent-free’ so to speak, for a period in excess of four years and further, that Plaintiff [lender] had been forced to bear the expense of both casualty insurance to protect its interest in the premises as well as the property taxes levied thereon by the Town of Brookhaven.

Id. at *2.

¹⁶¹ *See* HSBC Bank USA, N.A. v. McKenna, 952 N.Y.S.2d 746, 764–65 (N.Y. Sup. Ct. 2012).

¹⁶² Short-sale is the reference to an arrangement in which the lender agrees to permit the voluntary sale of the property and to accept less than the outstanding loan balance in order to release its mortgage and permit the sale. Of course, disagreements have arisen over whether the lender may thereafter hold the borrower responsible for payment of the remaining unsecured debt. *See* MADISON, DWYER & BENDER, *supra* note 17, § 17:14 (discussing California's legislative response to protect borrowers from any deficiency after the short sale).

¹⁶³ *See* McKenna, 952 N.Y.S.2d at 764–65.

interest where the nature and effect of the lender's breach of good faith render that remedy appropriate.¹⁶⁴

3. *Beyond Judge Spinner: The Reaches of Equity in the Subprime Crisis*

Although applying Main Street statutes to Wall Street securitizations dominated the judicial response to the subprime loan crisis, equity had its moments, particularly among trial judges such as Judge Spinner. Occasionally, equity flexed its potential to respond to unique characteristics of a mortgage crisis. A good example is the decision of New York Kings County Supreme Court Judge Herbert Kramer early in the mortgage crisis; the decision addressed rampant discrimination in targeting subprime borrowers of color for abusive terms.¹⁶⁵ Ordinarily, victims of discrimination bear the burden of proof, which is challenging in these times when lenders, employers, and landlords rarely reveal overt discriminatory intent.¹⁶⁶ With the burden of proof on plaintiffs, discrimination claims, if brought at all, tend to be brought by government officials and are poorly suited for redress by individual claimants with lesser enforcement resources.¹⁶⁷ Consistent with statutory norms, Judge Kramer initially required the borrower to demonstrate she was a victim of discriminatory lending.¹⁶⁸ Subsequent to that ruling, Judge Kramer looked to the high interest rate on the home loan (9.5%) made to the minority borrower, and the home's location in a minority neighborhood in Brooklyn, to announce a rebuttable presumption of discriminatory practices.¹⁶⁹ Effectively, Judge Kramer shifted the burden

¹⁶⁴ See *id.* at 767; see also *Wells Fargo Bank, N.A. v. Hughes*, 897 N.Y.S.2d 605, 609–10 (N.Y. Sup. Ct. 2010) (finding mortgagee bad faith in settlement conference negotiations and ordering the foreclosure dismissed without prejudice as the equitable remedy with no additional costs or attorney fees allowed upon any new action for foreclosure absent good cause).

¹⁶⁵ See *M & T Mortg. Corp. v. Foy*, 858 N.Y.S.2d 567, 568–69 (N.Y. Sup. Ct. 2008); see also *supra* Part IV.C (discussing discriminatory practices in subprime lending).

¹⁶⁶ See BENDER, *supra* note 102, at 170.

¹⁶⁷ See *M & T Mortg. Corp.*, 858 N.Y.S.2d at 569–72 (citing *Hargraves v. Capital City Mortg. Corp.*, 140 F. Supp. 2d 7, 20 (D. D.C. 2000)) (noting that the traditional placement of the burden of proof on a borrower to establish discrimination “renders illusory the possibility of meaningful legal redress,” and discussing a Fair Housing Act decision imposing the burden of proof on the claimant to demonstrate intentional targeting or disparate impact on the basis of race).

¹⁶⁸ See *id.* at 569. Presumably her claim was brought under the federal Fair Housing Act and the Equal Credit Opportunity Act. See generally BENDER, *supra* note 102, at 169–70 (discussing these housing discrimination laws).

¹⁶⁹ See *M & T Mortg. Corp.*, 858 N.Y.S.2d at 569.

of proof to the lender "[to] demonstrate by a fair preponderance of the evidence that the mortgage was not the product of unlawful discrimination," a presumption the lender could rebut by proving the mortgage terms were "given for nondiscriminatory economic reasons,"¹⁷⁰—in other words, by proving that the borrower's credit and the risks of the specific collateral justified the above-market rate. Surprisingly, equity supplied the jurisprudential flexibility to shift the burden of proving discrimination, an outcome with near monumental consequence for home mortgage discrimination.¹⁷¹ Citing the traditional maxim that equity "abhors unconscionable and unjust results," Judge Kramer opened his decision with two new equitable precepts: "Equity abhors discrimination" and "Equity will not enforce discriminatory practices."¹⁷² Thus, equity mandated a shift in the burden of proof for this high interest loan to a minority borrower.¹⁷³

Nevertheless, Kramer's decision reveals equity's limits in combatting unlawful discrimination. Apparently, Judge Kramer did not intend to shift the burden of proof for purposes of statutory remedies for discrimination.¹⁷⁴ Rather, his decision appears limited to the mortgagee's invocation of the equitable remedy of foreclosure.¹⁷⁵ Pursuant to Kramer's ruling, if the mortgagee is unable to demonstrate nondiscriminatory economic justification for the seemingly oppressive and discriminatory loan, "the foreclosure proceeding will be dismissed and the lender left to its remedies at law."¹⁷⁶ Therefore, the mortgagee would lose the equitable privilege of foreclosure, an action in rem, and instead would be relegated to suing the borrower on the mortgage note for an in personam judgment, presumably subject to statutory remedies should the borrower establish discrimination in those separate proceedings. Still, this judicial willingness to add anti-discrimination maxims to the equitable arsenal is a significant development in the fight against discriminatory practices and illustrates the potential flexibility of equity to respond to unique characteristics of a mortgage crisis.

Judge Kramer's anti-discrimination ruling also portends a broader role for equity in policing noncompliance with mortgage loan statutes and

¹⁷⁰ *Id.* at 568, 571.

¹⁷¹ *See id.* at 569–72.

¹⁷² *Id.* at 568.

¹⁷³ *See id.* at 572.

¹⁷⁴ *See id.* at 569–72.

¹⁷⁵ *See id.*

¹⁷⁶ *Id.* at 568.

regulations.¹⁷⁷ Akin to the illegality doctrine in contracts law that is sometimes invoked to urge invalidation of a mortgage or even the mortgage note for egregious statutory noncompliance as a matter of public policy,¹⁷⁸ equity can add to the arsenal of remedies for such statutes as the federal Truth in Lending Act,¹⁷⁹ and more importantly, it might punish noncompliance with obligations otherwise lacking a private right of action. In the latter context, several courts have addressed the absence of a private action under federal Department of Housing and Urban Development (HUD) mortgage servicing regulations mandating that lenders of FHA-insured loans, among other things, undertake a face-to-face interview with the defaulting borrower before foreclosure.¹⁸⁰ On the early side of the subprime foreclosure crisis, in 2007, the Maryland Court of Appeals joined other courts in invoking equity to police mortgagee noncompliance with these HUD foreclosure mitigation regulations.¹⁸¹ Recognizing that courts of equity will not aid those with unclean hands, defined to include fraudulent, illegal, or inequitable conduct, the court found that HUD noncompliance might constitute improper conduct, which would deny equitable relief of foreclosure.¹⁸² In 2010, however, the Indiana Court of Appeals refused to rely on equity to sanction noncompliance with these HUD regulations.¹⁸³ The court was concerned that applying the unclean hands doctrine to punish mortgagees would be too limited given the possibility that the mortgagor might also be seen in some way as having unclean hands, thus denying (or awarding) relief based on who is comparatively more innocent.¹⁸⁴ Rather, that court, while agreeing that the regulations do not give rise to a private

¹⁷⁷ Judge Spinner's rulings also suggest a broader role to supply an equitably-grounded remedial bite to New York's statutory mandate of foreclosure settlement conferences.

¹⁷⁸ The illegality defense is most common in connection with usury statute violations. *See, e.g.,* First Mut. Corp. v. Grammercy & Maine, Inc., 423 A.2d 680, 683 (N.J. Super. Ct. Law Div. 1980) (holding that defenses raised by mortgagors of usury and illegality are meritorious if proven).

¹⁷⁹ *See* Truth in Lending Act, 15 U.S.C. §§ 1601-1667(f) (2012).

¹⁸⁰ *See* 24 C.F.R. § 203.604 (2013).

¹⁸¹ *Wells Fargo Home Mortg., Inc. v. Neal*, 922 A.2d 538, 552-53 (Md. Ct. App. 2007); *see also* *Fleet Real Estate Funding Corp. v. Smith*, 530 A.2d 919, 922-24 (Pa. Super. Ct. 1987) (holding that a mortgagor of a FHA-insured loan can raise an equitable defense to foreclosure when the mortgagee violates HUD forbearance provisions).

¹⁸² *See Neal*, 922 A.2d at 552-53.

¹⁸³ *See Lacy-McKinney v. Taylor, Bean & Whitaker Mortg. Corp.*, 937 N.E.2d 853, 863 (Ind. Ct. App. 2010).

¹⁸⁴ *See id.*

action, read the regulations to require compliance as a condition precedent to foreclosure, thus circumventing equity and its unclean hands standard.¹⁸⁵

Although not explicitly invoking equity, Chief Justice Jean Toal of South Carolina's Supreme Court intervened judicially to facilitate the federal statutory loan modification program HAMP (Home Affordable Modification Program) and more broadly the imperatives of foreclosure mitigation through loan workouts.¹⁸⁶ Created under the Financial Stability Act of 2009, the HAMP program encourages and helps subsidize loan modifications by participating lenders and loan servicers. In order to allow borrowers the opportunity to benefit from the federal program, the Chief Justice issued an ex parte temporary restraining order halting all foreclosure sales in South Carolina under loans owned or guaranteed by Fannie Mae or Freddie Mac, or held by participating loan servicers, until it could be determined whether each loan was eligible for modification under HAMP.¹⁸⁷ In 2011, Chief Justice Toal delivered a more expansive order governing mortgage foreclosures of owner-occupied dwellings, applicable to all lenders and not just those participating in the HAMP program.¹⁸⁸ Chief Justice Toal's 2011 order denied any foreclosure hearing or sale until the mortgagee's attorney certified, among other things, that the mortgagee sent the borrower notice of any loan modification or other loss mitigation¹⁸⁹ company policies it follows and that, after giving the mortgagor the opportunity to apply and considering all the information submitted, the borrower was unqualified for relief.¹⁹⁰

¹⁸⁵ See *id.*

¹⁸⁶ See *Ex parte* Fed. Nat'l Mortg. Ass'n, 2009 WL 1249751, at *1 (S.C. May 4, 2009). For a discussion of HAMP, see *infra* text accompanying note 224.

¹⁸⁷ See *Fed. Nat'l Mortg. Ass'n*, 2009 WL 1249751, at *1.

¹⁸⁸ See Administrative Order *In re* Mortg. Foreclosure Actions, 720 S.E.2d 908, 909–10 (S.C. 2011).

¹⁸⁹ Presumably, this notice of policies would include those, if any, addressing short sales and deeds in lieu of foreclosure, or so-called friendly foreclosure agreements. See generally BENDER ET AL., *supra* note 8, at 397–409.

¹⁹⁰ See Administrative Order, *In re* Mortg. Foreclosure Actions, 720 S.E.2d at 910. However, commentators have pointed to outrageous timelines during the subprime crisis for completion of judicial foreclosures. See, e.g., Mike Sauter, *Cities With the Most Abandoned Homes*, USA TODAY (June 22, 2013, 8:06 AM), <http://www.usatoday.com/story/money/business/2013/06/22/cities-with-most-abandoned-homes/2447613/> (reporting that Florida foreclosures take almost 900 days on average to complete and 607 days in Indiana). Some observers might argue a conspiracy among judges to delay foreclosure sales in a time of crisis without invoking the dictates or discretion of equity. The recipe for delay, in the hands of trial judges, might be the consequence or opportunities of an overcrowded docket delaying the sought-after judgment of foreclosure. Appellate courts can weigh in with rulings, akin to

4. *Equity for Lenders*

From its inception, equity has shown its willingness to honor the compelling interests of lenders. Terminating the borrower's equitable right of redemption, accomplished initially in courts of equity by a decree of strict foreclosure as a prelude to today's statutory or equitable foreclosure sale, is a fundamental illustration of equity coming to the mortgagee's aid.¹⁹¹ Another example is the mortgagee's potential ability, in the absence of statutory or contractual authorization, to obtain appointment of a receiver in equity to collect property rents and guard against waste.¹⁹² A unique application of equity during the subprime crisis, implemented by a New Jersey chancery judge, demonstrates equity's flexibility, in this instance favoring a lender imperiled by the realities of securitization and its frenzy of note transfers.

Again, many courts insist on production of the signed promissory note as a condition of initiating and prosecuting foreclosure.¹⁹³ With loan originations preceding the subprime foreclosure crisis at a furious pace, multiple subsequent assignments, the advent of MERS documenting mortgage transfers electronically, the use of loan servicers separate from the note owner, and the desire to create bankruptcy-remote entities¹⁹⁴ to issue securities resulting in additional transfers of the note, chances were good the mortgage note might slip through these abundant cracks. Perhaps the original note remained in the originating lender's possession, and found its way to a landfill in a mountain of paperwork when that lender went defunct as the crisis took hold and originations ceased. Or the note made its way

the South Carolina court, that ostensibly carry out statutory objectives but practically delay foreclosure proceedings. Of course, even if judges consciously manipulated their discretion to achieve such delays, borrowers in nonjudicial foreclosure states would not enjoy the same relief. Thus, equity would remain a critical source of protection. Moreover, other legitimate factors explain the foreclosure delays, namely, in addition to overcrowded dockets, the unwillingness of some lenders to move the foreclosure action forward until values stabilized, the inability of some lenders to comply with emerging foreclosure requisites such as "show me the note" requirements, ongoing negotiations toward settlement undertaken in connection with new statutory obligations mandating such outreach, disagreement among investors on loan collection goals, the specter in some jurisdictions of property maintenance responsibilities imposed on mortgagees from the date of foreclosure judgments, and so forth.

¹⁹¹ See discussion *supra* Part II.

¹⁹² See discussion *supra* note 28. A further application of equity benefitting a mortgagee (at least a junior mortgagee) is the doctrine of marshaling at the behest of a junior creditor, whereby the senior creditor with an interest in two or more properties may be compelled in equity to first exhaust the collateral that the junior mortgage lien does not encompass. See generally Note, *The Equity of Marshaling*, 18 HARV. L. REV. 453, 453–34 (1905).

¹⁹³ See MADISON, DWYER & BENDER, *supra* note 17, § 12:35.

¹⁹⁴ See generally BENDER ET AL., *supra* note 8, at 811–14.

partially up the chain of ownership but was “lost” along the journey. Against these realities, the burden on the foreclosing lender bound by a “show me the note” requirement may be considerable. Perhaps through MERS, the lender (or other entity representing the securitized loan investors) can retrace past ownership and urge those owners to diligently search for the note. Yet if the note cannot be located, the foreclosing party is in a bind. Customarily, the party seeking to enforce a lost note prepares and files an affidavit of lost note with the court, attesting to the diligent but unproductive search. For mortgage notes subject to Article 3 of the UCC, which courts usually and perhaps simplistically assume governs mortgage loans,¹⁹⁵ those in possession of the note when lost can pursue its enforcement.¹⁹⁶ Of course, this alternative is little help in the context of most securitized loans where the party seeking to enforce the missing note never had possession. That party might react by fraudulently representing that it received possession before the note was lost, but accusations of and penalties for so-called robo-signing presumably discourage this wrongdoing. A 2002 amendment to the UCC, adopted in some states, allows additional parties to enforce the lost note—those who “directly or indirectly acquired ownership of the instrument” from someone in possession when the note became lost.¹⁹⁷ Even here, presumably the party seeking to enforce the note must identify exactly where the note was lost in the chain in ownership. Either with or without the aid of the UCC amendment, establishing the requisites of a lost note can prove challenging.

A New Jersey chancery ruling in 2011 arose in a state that failed to adopt the 2002 amendment, thus presumably limiting enforcement to the possessor of the note when it became lost.¹⁹⁸ When the residential mortgage loan in question was pooled, securitized, and transferred, an affidavit of lost note was prepared to reflect that the original lender had lost the note.¹⁹⁹ If the foreclosure court denied enforcement to the current owner of the note that relied on the affidavit in purchasing the loan, then presumably no one could enforce the note in default, resulting in a windfall the court deemed

¹⁹⁵ See generally Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What To Do About It?*, 37 PEPP. L. REV. 737, 768–69 (2010) (raising the dilemma of what rules should apply to mortgage notes falling outside the scope of Article 3).

¹⁹⁶ See U.C.C. § 3-309 (revised 1990) (amended 2002) (2013).

¹⁹⁷ *Id.* § 3-309(a)(1)(B).

¹⁹⁸ See *Bank of Am., N.A. v. Alvarado*, No. BER-F-47941-08, 2011 WL 145639 (N.J. Super. Ct. Ch. Div. Jan. 7, 2011).

¹⁹⁹ See *id.*

inequitable.²⁰⁰ Relying on the equitable doctrine of unjust enrichment in the context of the mortgage foreclosure action, the chancery court looked to the valuable consideration paid to purchase the note and the passage of time since the borrower's default in 2008 without another person making demand for payment. Accordingly, the court allowed Bank of America to enforce and foreclose on the lost note in equity.²⁰¹

D. Summary of the Equity Experience in Times of Mortgage Crisis

Before exploring the comparisons of equity to statutory intervention in the foreclosure process and to common law contract actions, and before suggesting what the appropriate role of equity might be, assessing the aggregate of the above equitable case law experience in times of mortgage crisis is helpful. Despite the potential for equity to operate as an unruly dog, in reality equity is quite controlled and leashed. Generally, the judicial application of equity is predictable and its protection of borrowers is restricted to egregious lender behavior or unconscionable circumstances. The following materials summarize the particular needs of borrowers during a mortgage crisis and what aid might be expected from equity in those difficult times.

Typically in times of economic crisis, mortgage credit tightens or disappears, the property market becomes a buyer's market for those with capital, and foreclosures mount. In these conditions, borrowers may desire a judicial moratorium on foreclosure to enable the market to recover, or to locate a replacement lender or employment. However, as seen during the Great Depression, judicial experience suggests hostility to claims in equity seeking delay of the foreclosure sale.²⁰² Relatedly, the unwillingness of most courts in equity to overturn the acceleration of the loan and initiation of foreclosure unless the mortgagee was somehow blameworthy suggests borrowers have little chance to seek an equitable delay during economic downturns. Lenders ultimately did delay foreclosures and regroup during the subprime crisis, but did so in response to widespread invalidations of foreclosures applying Main Street procedure laws, rather than as a consequence of equitable constraints.²⁰³

²⁰⁰ See *id.* Perhaps the original lender that lost possession of the missing note might enforce it if the lender is willing to repurchase the right to enforce the note. The originating lender in this case, however, was the now defunct Washington Mutual. See *id.*

²⁰¹ See *id.* The court did require Bank of America to stand ready to protect the borrower from double payment should another party appear and assert rights to enforce the note.

²⁰² See discussion *supra* Part IV.A.

²⁰³ See discussion *supra* Part IV.C.1.

Mortgage loans in times of financial distress often are underwater, particularly given low-down payments and the prospect of default interest and late fees that quickly raise the loan balance. Presumably, borrowers in distress would desire reduction of the principal balance to bring the loan and the borrower's equity stake in line with the reduced property value. Furthermore, the borrower might desire other modifications of key loan terms, particularly lowering an above market interest rate. The case law experience suggests equity holds little relief for borrowers. Equity does not appear to permit reduction or elimination of the principal balance as a sanction for inequitable conduct, although it may support the elimination of interest liability during the period of lender oppression or delay.²⁰⁴ Equity generally does not compel the reluctant lender to engage in workout negotiations with the borrower; its involvement seems limited to sanctioning lenders who fail to meet any statutory obligations to negotiate.²⁰⁵

For borrowers undergoing foreclosure, or reaching an agreement for a short sale in advance of foreclosure, their primary objective would be to reduce or eliminate any deficiency judgment. Equity's relief here is slight too. At its most protective, a few courts will impose an equitable fair market value standard to calculate the deficiency, thus protecting against a low foreclosure bid.²⁰⁶ Still, a fair market value standard is little comfort when values plummet during an economic crisis, and a disappointing foreclosure price leaves a large deficiency that nonetheless properly reflects the dismal market conditions. Relatedly, equity might impose an upset price before the judicial foreclosure sale, or overturn a sale for an outlandishly low foreclosure sale price—this equitable remedy is particularly helpful when no deficiency is sought but a low loan balance enabled the foreclosure sale purchaser to gain an unconscionable windfall from a borrower otherwise awaiting a surplus payment.

Understandably, equity will not protect a borrower who engages in misconduct. Evident in the subprime mortgage crisis is the potential for

²⁰⁴ See discussion *supra* Part IV.C.2.

²⁰⁵ See discussion *supra* Part IV.C.2; see also *Joselite v. Wachovia Mortg. Corp.*, 97 So. 3d 265, 266–67 (Fla. Dist. Ct. App. 2012) (holding a foreclosure sale valid despite the mortgagor and servicing agent having entered into a forbearance agreement several days before the sale; overturning sale in equity and finding that the trial court conclusion that a sale can only be vacated for grossly inadequate price or for sale defects deprives courts of their equitable powers to protect the integrity of the sale process). Securitized loans supplied a particularly difficult dynamic toward loan workouts, as the splitting of ownership interests into multiple levels of securitized risk sold to disparate investors surely jeopardized the chances of consent to a workout on the mortgagee side. See Super, *supra* note 13, at 109.

²⁰⁶ See discussion *supra* Part III.

unclean hands by those borrowers who abandon or affirmatively damage the property—for example, by stripping property fixtures. In the context of installment land contract forfeitures, courts reserve equitable intervention for borrowers who are not abandoning or absconding vendees.²⁰⁷ Presumably, borrowers seeking equitable relief in the context of a mortgage or deed of trust foreclosure must adhere to this same standard despite the temptation in a crisis to lash out in anger at the mortgagee or to recoup some of the borrower's losses by stripping the property.²⁰⁸

E. Foreclosure Protections in Times of Crisis: Legislatures v. Equity

Legislatures in many states have shown their willingness to enact borrower protections in times of mortgage crisis. Given the localized nature of foreclosure procedure, these laws tend to come from state legislatures, although the federal government has not forsaken emergency legislation.²⁰⁹ Both the Great Depression and the subprime mortgage crisis spurred significant protective legislation.

Prominent in the Great Depression legislative response were moratoria and antideficiency laws.²¹⁰ Led by Iowa in February 1933, twenty-six other states enacted moratoria laws during the next eighteen months.²¹¹ Varying in approach, these laws sometimes authorized courts to postpone judicial sale in individual cases, delayed the various procedural steps of the foreclosure process, or extended the statutory redemption period following the

²⁰⁷ See *supra* text accompanying note 20.

²⁰⁸ Outside of equity, for the purpose of construing antideficiency laws, some courts have distinguished between so-called bad waste caused by malicious bespoilers and good faith waste through deterioration in times of economic distress. In practice the distinction is challenging to apply. See *Cornelison v. Kornbluth*, 542 P.2d 981, 992–94 (Cal. 1975). See generally MADISON, DWYER & BENDER, *supra* note 17, § 17:21.

²⁰⁹ See, e.g., Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 701-704, 123 Stat. 1632, 1633 (2009).

²¹⁰ See also Note, *Mortgage Relief During the Depression*, 47 HARV. L. REV. 299, 302 (1933) [hereinafter *Mortgage Relief*].

²¹¹ See GEORGE E. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 331 (2d ed. 1970). Iowa's statute gave courts authority to continue the foreclosure sale unless good cause was shown to the contrary. See also *Fed. Land Bank of Omaha v. Wilmarth*, 252 N.W. 507, 514 (Iowa 1934) (upholding the district court's refusal to grant a foreclosure sale continuance on a showing that the mortgagor left the farm premises and allowed his son to rent the farmland to tenants who were not good farmers, and failed to apply the property rents to the mortgage debt and real estate taxes; in addition to having abandoned the farm, the mortgagor was insolvent and lacked any prospect of refinancing or paying the indebtedness within the moratorium period requested).

foreclosure sale.²¹² The Texas statute, for example, followed the first approach and authorized district court judges to grant continuances of the foreclosure sale to borrowers unable to pay their debt secured by property worth more than the loan that, given the economic distress and absence of bidding, would likely sell for less than the debt and thus foster inequity.²¹³ Some states relieved only borrowers who, despite having defaulted on a principal payment, were current in their payment of interest and real estate taxes.²¹⁴ Most laws were of temporary effect and by 1940 most had lapsed on their own terms or been repealed.²¹⁵ Courts invalidated some of these laws as unconstitutionally impairing preexisting contracts or because the emergency conditions that prompted their enactment no longer existed.²¹⁶ In contrast, the most prominent decision of the era, issued by the Supreme Court, upheld the constitutionality of Minnesota's foreclosure moratorium law.²¹⁷

²¹² See Wheelock, *supra* note 37, at 574 (discussing how some states left the extension of the redemption period to the court's discretion as was often done for moratoria before the foreclosure sale).

²¹³ See *Travelers' Ins. Co. v. Marshall*, 76 S.W.2d 1007, 1009 (Tex. 1934) (striking down a statute as an unconstitutional impairment of contract under the Texas constitution). The preamble of the Texas law included the following findings:

WHEREAS, the severe financial and economic depression existing for several years past has resulted in extremely low prices for the products of the farms, ranches and factories and a great amount of unemployment, and almost complete lack of credit for farmers, business men and property owners and a general and extreme stagnation of business, agriculture and industry; and

WHEREAS, many owners of real property by reason of such conditions are unable, and it is believed, will be for some time unable to meet all demands as they may become due for taxes, interest and principal of mortgages on their properties and are, therefore, threatened with loss of such properties through mortgage foreclosure and judicial sales thereof; and

WHEREAS, many such properties have been and are being bid in at forced sales for prices much below what is believed to be their real values, and often for much less than the amount of indebtedness constituting a lien upon the same, thus entailing deficiency judgments against the makers of such indebtedness and liens . . .

TEX. REV. CIV. STAT. ANN. art. 2218b pmbl. (repealed 1985).

²¹⁴ See Wheelock, *supra* note 37, at 574.

²¹⁵ See OSBORNE, *supra* note 211, § 331.

²¹⁶ See, e.g., *Travelers*, 76 S.W.2d at 1025 (holding that Texas law violates the state constitution prohibiting impairment of obligation of contracts).

²¹⁷ See *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 416 (1934) (upholding the Minnesota Mortgage Moratorium Law, enacted in 1933, against challenge under the federal

In addition to moratoria law, during the Great Depression several states enacted laws restricting lender recovery of deficiency judgments. In similar fashion to moratoria laws, deficiency laws were quite diverse, encompassing approaches that substituted fair market value for the foreclosure sale price in calculating the deficiency, and that denied a deficiency altogether in certain circumstances, such as following the foreclosure of a purchase money mortgage.²¹⁸ Like the moratoria laws, some antideficiency statutes were challenged as impairing lender contracts (notably, the Supreme Court upheld New York's fair market value law).²¹⁹ In contrast to the moratoria law experience, most of these Great Depression era antideficiency laws, such as New York's law,²²⁰ endured through the years without repeal after

Constitution; the law allowed for a foreclosure sale to be postponed and also for redemption periods to be extended "for such additional time as the court may deem just and equitable"; the Court found that economic emergency justified the temporary legislation). Earlier Supreme Court decisions addressing legislative responses to similar crises struck down related laws. *See, e.g.,* *Barnitz v. Beverly*, 163 U.S. 118, 132 (1896) (striking down a Kansas law passed during the 1893 panic that extended the redemption period eighteen months); *Daniels v. Tearney*, 102 U.S. 415, 416 (1880) (striking Virginia moratorium law as unconstitutional because it suspended debt collection indefinitely "until otherwise provided by law"). *See generally* A. H. Feller, *Moratory Legislation: A Comparative Study*, 46 HARV. L. REV. 1061, app. 1 (1933) (listing state moratorium laws and cases deciding their constitutional validity).

²¹⁸ *See* Comment, *Recent Legislation for the Relief of Mortgage Debtors*, 42 YALE L.J. 1236 (1933) (discussing the variety of Great Depression-era antideficiency laws); Wheelock, *supra* note 37, at 574–75 (supplying an example of Montana law that outlaws deficiencies under purchase money loans); *see also* WASH. REV. CODE ANN. § 61.12.060 (West 2013) (authorizing a fair market value hearing in confirming the foreclosure sale, and alternatively the judicial designation of a pre-sale upset price—this law was enacted in 1935 and is still operative: "The court, in ordering the sale, may in its discretion, take judicial notice of economic conditions, and after a proper hearing, fix a minimum or upset price to which the mortgaged premises must be bid or sold before confirmation of the sale"); OSBORNE, *supra* note 211, § 335 (discussing the Great Depression-based rationale for the fair market value approach). Another statutory approach was to impose strict statutes of limitations on the initiation of the deficiency action to give the borrower some respite going forward if the economy improved. *See* Wheelock, *supra* note 37, at 574–75. Following the subprime foreclosure crisis, some borrowers in states without such laws experienced deficiency actions brought long after their homes were foreclosed. *See* Kimbriell Kelly, *Lenders Seek Court Actions Against Homeowners Years After Foreclosure*, WASH. POST (June 15, 2013), http://www.washingtonpost.com/investigations/lenders-seek-court-actions-against-homeowners-years-after-foreclosure/2013/06/15/3c6a04ce-96fc-11e2-b68f-dc5c4b47e519_story.html.

²¹⁹ *See* *Gelfert v. Nat'l City Bank of N.Y.*, 313 U.S. 221, 235–36 (1941) (upholding a law against attack under the contract clause of the federal Constitution because the fair market value law is consistent with the intent of the loan contract for the mortgage lender to receive payment in full by protecting against it being paid more than once through double recovery of money judgment and property acquired in foreclosure sale).

²²⁰ *See* N.Y. REAL PROP. ACTS. LAW § 1371(2) (McKinney 2013).

the Great Depression faded, representing “the most significant and enduring legislative impact of mortgage law arising out of the great depression.”²²¹

Legislative relief during the subprime crisis took a different approach, focusing on encouraging loan modifications and workouts between the borrower and lender. Some laws had a flavor of moratoria, as a number of states mandated a pre-foreclosure notice detailing foreclosure relief services and supplying the borrower additional time to seek help before commencement of foreclosure. For example, New York required sending the borrower a ninety-day pre-foreclosure list of government-approved housing counseling agencies.²²² Many laws specified mandatory mediation or judicial settlement conferences at the impetus of the borrower. For example, New York required a mandatory judicial settlement conference, during which the mortgagor and mortgagee negotiate in good faith toward “a mutually agreeable resolution, including a loan modification, if possible.”²²³ Relatedly, the federal government enacted the Home Affordable Modification Program (HAMP), supplying financial incentives toward the alteration of payment schedules for principal residence loans in which the borrower is in financial distress and the mortgage payment exceeds 31% of monthly income.²²⁴ None of these laws, however, mandates the actual modification of loans.²²⁵

²²¹ GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 8.3, 715 (5th ed. 2007).

²²² N.Y. REAL PROP. ACTS. LAW § 1304 (McKinney 2013) (requiring pre-foreclosure notice for all loans secured by principal dwelling and effective until January 14, 2015, thereafter the law is applicable just for high-cost residential loans). As an additional example, Colorado allowed borrowers a ninety-day deferment of foreclosure if they pursued financial counseling. *See* COLO. REV. STAT. ANN. § 38-38-803(6) (West 2013). Enacted in 2008, California law required lenders to wait thirty days before initiating foreclosure, during which time they are required to contact the borrower to explore options to avoid foreclosure. *See* CAL. CIV. CODE § 2923.5(a)(1) (West 2013). *See generally* Aleatra P. Williams, *Foreclosing Foreclosure: Escaping the Yawning Abyss of the Deep Mortgage and Housing Crisis*, 7 NW. J.L. & SOC. POL’Y 455, 495–503 (2012) (detailing the Great Depression era and subprime legislative reform that protected borrowers).

²²³ N.Y. C.P.L.R. 3408 (McKinney 2013); *see also* *Foreclosure Mediation Programs by State*, NAT’L CONSUMER LAW CTR., <http://www.nclc.org/issues/foreclosure-mediation-programs-by-state.html> (last visited Feb. 1, 2014) (supplying links and resources for twenty-five state laws).

²²⁴ *See generally* W. Justin Jacobs, Note, *Help or Hamp(er)?—The Courts’ Reluctance to Provide the Right to a Private Action Under HAMP and its Detrimental Effect on Homeowners*, 47 VAL. U. L. REV. 267, 277–78 (2012). Effective until the end of 2015, another federal mortgage loan modification program, the Home Affordable Refinance Program (HARP) augmented HAMP through a program aimed at performing loans owned or guaranteed by Fannie Mae or Freddie Mac secured by underwater properties. *See* *Home Affordable Refinance Program (HARP)*, MAKING HOME AFFORDABLE, <http://www.making>

Comparing the relative benefits and detriments of protecting borrowers in times of economic crisis by legislation or judicial equity yields mixed results in light of the above judicial and legislative experience. Arguing for legislative intervention is the reluctance of some courts to expand the scope of traditional equitable intervention. For example, New York's Appellate Division, rejecting a mortgagor's request in equity to decree a moratorium of a Great Depression-era foreclosure, suggested that if "hardship ensues, it is for the Legislature and not the courts to take cognizance of that fact."²²⁶ If the legislature fails to take the lead, the borrower tends to be left to the vacillating morals of the marketplace. Legislation also better influences mortgagee conduct, as meaningful equitable relief might otherwise be sporadic and confined to a few rogue judges such as New York's Judge Spinner. Lenders therefore might discount equitable intervention as limited to the unique set of facts in which a particular decision arises, whereas legislative intervention tends to specify standards more broadly and clearly, thereby increasing the likelihood of lender compliance. Equity also tends to require the hiring of lawyers by borrowers to assert equitable arguments in the context of foreclosure proceedings—either in the judicial foreclosure action or by filing a motion to enjoin a nonjudicial sale, which might additionally require the posting of some bond to protect the lender's interests. Nevertheless, many legislative interventions contemplate the hiring of lawyers to advocate for borrowers, such as when Great Depression era laws gave courts the authority to postpone the foreclosure sale in judicially determined circumstances, or to determine the property's fair

homeaffordable.gov/programs/lower-rates/Pages/harp.aspx (last updated Apr. 12, 2013 2:00 PM).

²²⁵ In addition to laws prompting mediation or otherwise encouraging loan modifications, other laws protected borrowers in the modification or foreclosure process, such as California's law, enacted in 2010, to ensure lenders agreeing to a short sale cannot thereafter hold their borrowers liable for a deficiency judgment to recover the shortfall. *See* CAL. CIV. PRO. CODE § 580(d) (West 2013). *See generally* MADISON, DWYER & BENDER, *supra* note 17, § 17:14.

Complementing laws protecting borrowers in foreclosure were a rash of state and federal laws protecting tenants occupying foreclosed residences. *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 701-704, 123 Stat. 1632, 1633 (2009) (sunsetting at the end of 2014, the Act entitles residential tenants to remain on the property until the lease ends or, if earlier, when the property is sold to a buyer intending to occupy it as a principal residence, in which event ninety days' notice to vacate must be given).

²²⁶ *Strochak v. Glass Paper Making Supplies Co.*, 267 N.Y.S. 282, 284 (N.Y. App. Div. 1933).

market value, which often involves a judicial “battle of the appraisers” with expert witnesses managed by counsel for both parties.²²⁷

Lenders might favor equitable intervention by courts over legislation that lingers long past the emergency conditions that prompted legislative action (particularly evident for antideficiency laws enacted during the Great Depression). Arguably benefitting both parties, equity can shape relief to coincide with the particular economic crisis, without the need for artificial predictions of when legislation should sunset in light of an anticipated turnaround in financial conditions. Also, legislation tends to favor a one-size-fits-all solution rather than individualized determinations of inequity, thus sometimes rewarding unclean hands. As one commentator suggested during the Great Depression:

[J]udicial consideration of the conflicting interests in the individual case seems more desirable than blanket legislation. Particularly is this so of moratory relief. While there are many deserving landowners in danger of losing their property through debts made unbearable by an unexpected deflation of the dollar, there are others who do not merit extraordinary relief: the speculator whose investment in the land has been negligible, the solvent opportunist who wilfully refuses to meet his obligations, the judgment-proof debtor who with impunity milks the property.²²⁸

For example, during the subprime mortgage crisis, many lenders decried borrowers, particularly those with evident means to perform, who strategically defaulted to flush mortgage debt from underwater properties in antideficiency jurisdictions.²²⁹ While not pinpointing relief as precisely as an equity court, legislation nonetheless can allocate protection to just residential borrowers to the exclusion of commercial loans, or to certain categories of residential borrowers, such as several states did during the

²²⁷ See Wheelock, *supra* note 37, at 574 (noting that some states assigned the determination of fair market value to local appraisal boards rather than courts).

²²⁸ *Mortgage Relief*, *supra* note 210, at 306–07 (suggesting, in contrast, that legislation is valuable for its immediacy).

²²⁹ See Kenneth R. Harney, *Professor Advises Underwater Homeowners to Walk Away from Mortgages*, L.A. TIMES (Nov. 29, 2009), articles.latimes.com/2009/nov/29/business/la-fi-harney29-2009nov29 (presenting lender representatives’ arguments that strategic default is immoral); see also Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971, 985 (2010).

subprime crisis by protecting just high-cost residential mortgage loans or primary residence loans (and thus not investor-owned homes or vacation homes).²³⁰ Earlier, in Great Depression era legislation, moratoria laws generally addressed just farm and residential property, although New York's law encompassed commercial real estate.²³¹

From the perspective of the mortgagor, equity supplies the advantage of eluding constitutional attack as an impairment of contract, because equitable constraints are part of the background principles of state law that all lenders must anticipate in their contractual behavior.²³² Generally, however, legislation and judicial equity have worked well in tandem and often complement each other in a symbiotic relationship. For example, Great Depression moratoria legislation usually relied on courts to implement legislatively authorized discretion to postpone judicial sales.²³³ Conversely, sometimes the imposition of judicial equity helped spur legislative reform, as occurred in Wisconsin when the legislature codified a fair market value standard in 1935 after the Wisconsin Supreme Court adopted an equitable fair market measure in 1933.²³⁴ Although the legislature could, if it so desired, squelch the imposition of equity by unambiguously eliminating or

²³⁰ See MADISON, DWYER & BENDER, *supra* note 17, § 19:2 (describing the New York laws governing high-cost loan foreclosures). The Home Foreclosure Procedures Act, being developed for state adoption by the National Conference of Commissioners on Uniform State Laws, contemplates its application to foreclosures on residential property. See DRAFT: HOME FORECLOSURE PROCEDURES ACT, NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAW § 103 (2013), available at http://www.uniformlaws.org/shared/docs/Residential%20Real%20Estate%20Mortgage%20BForeclosure%20Process%20and%20Protections/2013AM_H_FPA_Draft.pdf.

²³¹ See Wheelock, *supra* note 37, at 579.

²³² See *Mortgage Relief*, *supra* note 210, at 306 (explaining how equity decisions of state courts avoid concerns of the denial of due process and the impairment of contracts that plagued statutes of the Great Depression era).

²³³ See *supra* notes 212–213 and accompanying text; see also KAN. STAT. ANN. § 60-2415 (West 2013) (specifying the equitable powers of the court to decline to confirm a foreclosure sale where the bid is substantially inadequate, or alternatively, set a minimum price at which the property must sell for the sale to be confirmed). See generally KAN. STAT. ANN. § 60-2415 (West 2013), construed in *Citifinancial Mortg. Co., Inc. v. Clark*, 177 P.3d 986, 989–91 (Kan. Ct. App. 2008).

²³⁴ See *Suring State Bank v. Giese*, 246 N.W. 556, 557–58 (Wis. 1933); see also WIS. STAT. ANN. § 846.165(2)(i) (West 2013); *Gelfert v. Nat'l City Bank of N.Y.*, 313 U.S. 221, 231–33 (1941) (recognizing that equity and the legislature have worked together to ensure fair value is received at the foreclosure sale, with equity occasionally setting upset prices for confirmation of the foreclosure sale or striking down sales where the sale price is so inadequate it shocks the court's conscience, and with legislatures enacting fair market value laws for calculating any deficiency).

reducing those powers in a statutory directive, legislatures rarely take such action. Equity also intervenes to help enforce laws protecting the mortgagor, as in the case of Judge Spinner and other New York trial judges sanctioning bad faith settlement efforts under New York's mandatory foreclosure settlement conferences,²³⁵ and judges ensuring compliance with the federal HAMP program.²³⁶

F. Comparison of Equity to Common Law Contract Claims

In 2012, Professor George Cohen urged homeowners caught in the foreclosure crisis to invoke common law contract claims—particularly those excusing performance—to escape underwater loans without liability or to modify their terms.²³⁷ Acknowledging the barriers of these judicial claims in times of economic crisis, Cohen called on courts to flexibly apply and expand conventional contract theory to account for prevailing dismal economic conditions.²³⁸ Suggesting that the traditional tripartite of excuse doctrine theories (impracticability, frustration of purpose, and mistake) are a good doctrinal catalyst for mortgagor relief, Cohen recognized that borrowers are not invoking these theories, perhaps because at first glance these doctrines do not appear to excuse payment that is made more difficult in times of crisis.²³⁹ Yet, Cohen lays a blueprint for litigators and favorably

²³⁵ See discussion *supra* Part IV.C.2.

²³⁶ See Rebekah Cook-Mack & Sarah Parady, *Enforcing the Home Affordable Modification Program Through the Courts*, 44 CLEARINGHOUSE REV. 371, 372 (2010) (citing and discussing trial judges denying mortgagees summary judgment of foreclosure based on incorrect or incomplete assessments of borrower eligibility under HAMP); see also *In re Cruz*, 446 B.R. 1 (Bankr. D. Mass. 2011) (enjoining a trustee's sale based on alleged lender breach of HAMP).

²³⁷ See George M. Cohen, *The Financial Crisis and the Forgotten Law of Contracts*, 87 TUL. L. REV. 1, 26–32 (2012).

²³⁸ See *id.* at 54.

²³⁹ See *id.* This reasoning is borne out by the sparse case authority in the subprime crisis in which mortgagors invoked excuse doctrines. For example, in 2009 an arbitrator issued a ruling that enjoined a foreclosure sale of a condominium development in Long Beach, California, on the theory that the residential credit freeze and consequent lack of resale market created an impossibility of performance. See Erika Schnitzer, *In Dispute Between Developer and Lender, Arbitrator Finds in Favor of Former*, MULTI-HOUSING NEWS (MAY 22, 2009), <http://www.multihousingnews.com/news/in-dispute-between-developer-and-lender-arbitrator-finds-in-favor-of-former/1003976065.html>. Equity cases have suggested that parties have allocated risks of consequent catastrophic declines in value that should not be disturbed. See, e.g., *Morris v. Waite*, 160 So. 516, 518 (Fla. 1935) (denying the equitable moratorium of foreclosure in a Great Depression era case because the economic decline affects both parties, and “[c]ontracts of this character are made in anticipation of the fact that

disposed courts by arguing how subprime lender conduct exacerbated economic risks that should not be allocated to borrowers.²⁴⁰

Most courts would likely disfavor modifying payment terms or forgiving some or all of the principal indebtedness on grounds of mistake, frustration, or impracticability, fearing the slippery slope of mass reallocation of risk to lenders or those owed a money performance. Equity supplies an opportunity for more pointed relief attendant to real estate foreclosures, but again, equity generally has not seen fit to modify contractual terms. Because the next section argues for a more flexible application of equity, Cohen's arguments are best fit as complementary to an expanded use of equity should courts in fact be willing to rely on common law theories of more general application instead of judicial equity.

Given past judicial experience, some common law contracts theories seem particularly ill-suited to rescue mortgagors in a financial crisis. For example, the claim of unconscionability looks to circumstances of oppression and unfairness existing at the time the contract was made, which presumably does not allow for consideration of compelling emergency conditions that arose later to prompt default and inability to perform.²⁴¹ In contrast, equity is flexible enough to permit consideration of the particular circumstances prevailing at the date of foreclosure.

conditions may change and that the . . . security may have so depreciated in value as to be insufficient to bring the amount of the debt").

²⁴⁰ See Cohen, *supra* note 237, at 54–59.

²⁴¹ See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) ("If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract. . ."); see also U.C.C. § 2-302 (2013). Nevertheless, some subprime loans were doomed to fail based on an improper assessment of the borrower's ability to perform, absent a robust market where the borrower might flip the home for profit or refinance the loan to avoid default from a shortfall of income and inability to afford the loan payments. This scenario of lending to a borrower incapable of performance is a classical application of the unconscionability doctrine. Federal legislative reform ultimately addressed the inability to pay issue, with section 129B of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2009 requiring creditors to make a "reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan." 15 U.S.C. § 1639c(a)(1) (2012); see also MADISON, DWYER & BENDER, *supra* note 17, § 14:13 (discussing a mortgagor's claims for the inability to afford a loan brought on the theory that the lender fraudulently failed to disclose that inability or manipulated the borrower's income to approve the loan).

Equity opinions frequently refer interchangeably to the borrower's predicament as both inequitable and unconscionable.²⁴² Equity might therefore share the same critique as the unconscionability doctrine—often maligned for its indeterminacy.²⁴³ Although critiqued as standardless, the record of application of both unconscionability and equity should quiet these critics. As in the case of the narrow situational impositions of equity,²⁴⁴ the unconscionability experience has been one of restrained application by courts to address only egregious unfairness.²⁴⁵

Furthermore, the retrenchment of common law good faith covenant claims in the courts, which coincided with the savings and loan crisis, left some borrowers stripped of their equity or faced with deficiency claims.²⁴⁶ That experience continued into the subprime crisis. For example, a residential borrower in Oregon participated in a trial loan modification program under which she made three reduced monthly payments pursuant to an agreement that upon such compliance Chase bank would “consider a permanent workout solution for [her] loan.”²⁴⁷ The borrower alleged that Chase repeatedly represented the trial plan was a condition precedent to an automatically triggered permanent workout, but Chase ultimately failed to

²⁴² See, e.g., *Vonk v. Dunn*, 775 P.2d 1088, 1091 (Ariz. 1989) (en banc); *IndyMac Bank F.S.B. v. Yano-Horoski*, 890 N.Y.S.2d 313, 317 (N.Y. Sup. Ct. 2009), *rev'd*, 912 N.Y.S.2d 239 (N.Y. App. Div. 2010).

²⁴³ For such critiques of unconscionability, see WALTER K. OLSON, *THE LITIGATION EXPLOSION* 211 (1991) (describing unconscionability as a standard of “almost dreamlike floating indeterminacy”); see also Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 488 (1967) (describing the UCC standard for unconscionability as one of “amorphous unintelligibility”). The good faith standard in contract law presents similar uncertainties as unconscionability when applied to mortgage loans in default. See generally Freyermuth, *supra* note 23, at 1041 (critiquing the Restatement (Third's) exception to the enforcement of acceleration clauses in the case of mortgagee bad faith as creating the potential for uncertainty in application).

Among the connections between unconscionability and the application of equity to mortgage foreclosures is the branch of unconscionability and procedural unfairness that Professor Leff labeled as the search for bargaining naughtiness. See Leff, *supra*, at 487. Similarly, the insistence by some courts in equity of a finding of lender misconduct, reflects the same emphasis on lender misconduct, coupled with substantive oppression.

²⁴⁴ See *supra* Part III.

²⁴⁵ See, e.g., Melissa T. Lonegrass, *Finding Room for Fairness in Formalism—The Sliding Scale Approach to Unconscionability*, 44 LOY. U. CHI. L.J. 1, 4 (2012) (discussing how through judicial formalism and sentiment against judicial activism, the unconscionability doctrine “has been an ineffectual tool for consumer protection,” while suggesting a strategy for its ascendancy in regulating consumer standard form contracts).

²⁴⁶ See *supra* Part IV.B.

²⁴⁷ *Barinaga v. JP Morgan Chase & Co.*, 749 F. Supp. 2d 1164, 1170 (D. Or. 2010).

offer a permanent modification.²⁴⁸ Because the borrower was in default and the loan documents authorized foreclosure, consistent with the *Uptown Heights*²⁴⁹ decision discussed previously, the court ruled that the lender had no implied contractual duty to offer a permanent loan modification.²⁵⁰

Interestingly, opportunities for borrowers victimized by apparent bad faith may exist in the equitable jurisdiction of courts, particularly when that jurisdiction is invoked before the foreclosure sale. For example, in the *Uptown Heights* litigation, the court rejected bad faith and intentional interference claims against a lender who refused to postpone the scheduled foreclosure sale to allow a voluntary sale to conclude that would have recouped some of the borrower's equity stake.²⁵¹ Pursued after the foreclosure sale that fully satisfied the loan, these claims would not invoke the court's equitable jurisdiction.²⁵² Yet, consider if the borrower in *Uptown Heights* had sued to enjoin the trustee's sale upon learning of the lender's refusal to postpone the imminent foreclosure sale.²⁵³ Invoking the court's equitable jurisdiction, the borrower might claim that, akin to case authority holding initiation of foreclosure potentially inequitable,²⁵⁴ conducting the scheduled foreclosure sale without postponement would be inequitable.²⁵⁵

²⁴⁸ See *id.* at 1171.

²⁴⁹ *Uptown Heights Assocs. Ltd. P'ship v. Seafirst Corp.*, 891 P.2d 639, 647–48 (Or. 1995); see also *supra* notes 86–95 and accompanying text.

²⁵⁰ See *Barinaga*, 749 F. Supp. 2d at 1180–81 (refusing to distinguish *Uptown Heights* on grounds that it involved a commercial lender and the loan in the present case was residential; refusing, however, to dismiss the fraud claim). But see *Aceves v. U.S. Bank, N.A.*, 120 Cal. Rptr. 3d 507, 519 (Cal. Ct. App. 2011) (holding that a borrower may pursue a promissory estoppel claim for relying on U.S. Bank's promise to work with her in modifying the home loan in exchange for the borrower foregoing further Chapter 13 bankruptcy proceedings).

²⁵¹ See *Uptown Heights*, 891 P.2d at 643–48.

²⁵² See *id.* at 642. Because the lender credit bid the amount of the loan, there was no deficiency sought for which the borrower might claim a fair market value credit. Moreover, given that the proposed purchase contract provided a price range of between \$8.1 and \$8.6 million (presumably based on rental occupancy at closing), the foreclosure sale price at worst was over 90% of the property's fair market value and safely outside the range of prices that might constitute a gross inadequacy shocking the court's conscience.

²⁵³ See *id.* The lender conveyed its rejection on November 7, 1991, more than two weeks after the borrower's request on October 22, 1991.

²⁵⁴ See *supra* text accompanying note 23.

²⁵⁵ Although the lender might contend the third party purchaser need simply bid at the sale, in *Uptown Heights* that party needed additional time to secure financing. See *Uptown Heights*, 891 P.2d at 642. Even if the purchaser was able to obtain financing in time to bid at the sale, it would have no incentive to bid more than a nominal amount in excess of the

Given the traditional approach that restricts such equity to situations where the lender is somehow blameworthy, however, many courts would likely reach the same outcome—no relief apart from the lender’s mercy—whether pursued in equity before the foreclosure sale or as a good faith claim after the sale. Nevertheless, an equity claim offers at least the prospect, in a jurisdiction hostile to contractual good faith, of a different outcome by using the separate and more situational theory of equity.

V. RUMINATIONS ON EQUITY’S POTENTIAL IN TIMES OF MORTGAGE CRISIS

The subprime foreclosure crisis set perhaps the best stage for a performance by equity. In contrast to the failed commercial property loans that precipitated the savings and loan crisis, residential foreclosures were the face of the subprime crisis. Despite controversy over laying blame for the subprime crisis,²⁵⁶ many borrowers were victimized by predatory loans.²⁵⁷ The lending model of Main Street lending that dominated pre-Great Depression²⁵⁸ eventually gave way to Wall Street securitizations orchestrated by loan originators, servicing companies, investment bankers, and investors with little influence in the local courts. The devastating consequences of the foreclosure crisis on cities and towns had far more visible impacts on local “Main Streets” than the effects of the defaulted loans on disparate national and international investors having no discernable presence in the towns and cities suffering foreclosure’s hubris.²⁵⁹ With this

lender’s credit bid, absent competitive bidding from additional third parties with their own arranged financing.

²⁵⁶ See *supra* note 117 and accompanying text.

²⁵⁷ See BENDER, *supra* note 102, at ch. 5.

²⁵⁸ Compare the Great Depression era sentiment for the vulnerability of lenders expressed in *Loma Holding Corp. v. Cripple Bush Realty Corp.*, 265 N.Y.S. 125 (N.Y. Sup. Ct. 1933), *aff’d*, 193 N.E.272 (N.Y. 1934):

How can any court say that defendant, who has borrowed money on property and spent it extravagantly or invested it unwisely, is entitled to any more sympathy than the man who has, after a lifetime of hardship and thrift, accumulated money which he lends at a reasonable rate of interest?

Id. at 131.

²⁵⁹ Prompted by the deleterious impact of residential foreclosures on borrowers and the surrounding community, some sheriffs simply refused to hold court-ordered foreclosure sales, exercising their police power in a manner akin to equitable intervention. See, e.g., Michael M. Phillips, *He’s Taking the Law Into His Own Hands to Help Broke Homeowners*, WALL ST. J. (June 6, 2008 12:01 AM), <http://online.wsj.com/article/SB121271135166050537.html>; see also Robert A. Franco, *Sheriff Refuses to Serve Evictions Resulting from Foreclosures*, SOURCE OF TITLE BLOG (Oct. 9, 2008), http://www.sourceoftitle.com/blog_

background, considerable intervention by judicial equity in the foreclosure process was possible but unrealized.

Several factors may explain why equity did not materialize as a critical and widespread weapon in the hands of borrowers during the subprime crisis. Equity requires lawyers to effectively argue its imposition, and borrowers strapped for cash and often unemployed struggled to find lawyers, particularly when equitable remedies normally did not involve some financial recovery from which the lawyer might draw a contingency fee. Equitable victories at the trial court level may be unreported and may have helped prompt settlements through loan modifications, forbearance, or short sales, rather than the lender risking an unfavorable reported decision on appeal—particularly where the lender or foreclosure claimant is accused of inequitable behavior. Lawyers found success arguing Main Street laws to stave off many subprime foreclosures, rather than resorting to the limited and more case-specific applications of equity that often required some lender misconduct.²⁶⁰ Based on sloppiness or ignorance rather than misconduct, these statutory victories tended to successfully delay foreclosures en masse as lenders were sometimes forced to refile the foreclosure action and start from scratch,²⁶¹ while ensuring their other loan files complied with the newly announced judicial interpretations of statutory requisites. Finally, with the increasing conservatism of judges, some may have perceived equitable intervention as judicial policy making to be avoided given the strong presence of legislation in dictating the foreclosure process.

Rather than dwell more on the equitable experience in the recent subprime crisis and suggest what courts should have done, this Article's aim here is to look toward the inevitable next slump in real estate and suggest how equity might better serve borrower (and lender) interests. Admittedly, such suggestions for reform were formed in light of personal biases. Rather than awarding one-size-fits-all solutions, courts in equity should afford greater relief toward certain mortgagors. Specifically, courts should afford residential borrowers greater relief than commercial

node.aspx?uniq=402 (discussing Cook County, Illinois sheriff who suspended post-foreclosure evictions).

²⁶⁰ See *supra* Part IV.C.1. Equity is ill-suited for class action treatment, as are many if not most of the relevant common law contracts claims. In contrast, statutory claims, such as those construed to require possession and production of the original promissory note, had class-wide impact during the subprime crisis as lenders scrambled to ensure compliance.

²⁶¹ See, e.g., *Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 458–59 (N.J. Super. Ct. Ch. Div. 2010) (dismissing a foreclosure complaint for lack of possession of note without prejudice to initiate a new action).

borrowers.²⁶² Residential borrowers, particularly for securitized loans, are handed take-it-or-leave-it loan documents, whereas commercial borrowers often have the benefit of both legal counsel at the drafting stage and the leverage to negotiate favorable terms, such as nonrecourse provisions,²⁶³ that can supply protection in the event of default. Residential borrowers gain additional standing with longevity of tenure at their residence,²⁶⁴ and also when the subject of foreclosure is their principal residence rather than an investment property or a vacation home. Borrowers who remain in their residence rather than abandon the property have the highest claim to equity in my opinion.

With this disclosed background of bias toward borrowers on loans secured by their primary residence, the remainder of this section suggests how courts might better address their needs in the next financial crisis and concludes with a discussion of the potential equities favoring lenders.

A. Modification-Workout

Case law from the subprime crisis suggests that while equity might punish lenders who fail to comply with statutory dictates encouraging foreclosure mitigation, equity will not compel the terms of loan modifications.²⁶⁵ In a 2012 article, Daniel Bahls and Katherine Hunt, two legal aid lawyers specializing in foreclosure mitigation, argued that courts in equity should consider modifying mortgage loans for residential borrowers wishing to remain in their homes.²⁶⁶ Bahls and Hunt urged a foreclosure judgment reducing the mortgage note to the property's appraised value and the prevailing market interest rate, and they suggested that the court only authorize a foreclosure sale should the borrower fail to execute the modified

²⁶² Farms seem to fall more toward the commercial side of the ledger given the increasing corporatization and consolidation of the agricultural industry.

²⁶³ See generally BENDER ET AL., *supra* note 8, at 256–69. For an illustration of courts in equity relying on the sophistication and financial wherewithal of commercial borrowers to deny relief, see *First Bank v. Fischer & Frichtel, Inc.*, 364 S.W.3d 216, 223 (Mo. 2012) (en banc).

²⁶⁴ Cf. *Potter v. Oster*, 426 N.W.2d 148, 152 (Iowa 1988) (invoking equitable remedies in an installment land contract case based on the sentimental value of the residence rather than economic value).

²⁶⁵ Relatedly, in labor negotiations, despite the obligation to bargain in good faith under the federal National Labor Relations Act, the National Labor Relations Board has no power to impose substantive contractual terms as a remedy for bad faith bargaining given the freedom of contract policies underlying that Act. See *H.K. Porter Co. v. N.L.R.B.*, 397 U.S. 99, 101–02 (1970).

²⁶⁶ Daniel Bahls & Katherine Hunt, *Abhorring a Forfeiture: The Importance of Equitable Jurisdiction in a Foreclosure Crisis*, 41 STETSON L. REV. 779, 809–10 (2012).

note and begin payments thereunder.²⁶⁷ No case authority directly supports this equitable intervention.²⁶⁸ Bahls and Hunt rely primarily on two decisions from the Great Depression era, which justified broad equitable discretion.²⁶⁹ In one of them, a trial judge equitably stayed the foreclosure sale, but the Illinois Appellate Court overturned the ruling as beyond the court's equitable authority.²⁷⁰ In the other, discussed above, the Wisconsin Supreme Court imposed a fair market value restriction on recovery of a deficiency judgment.²⁷¹ A fundamental difference exists, however, between authorizing reduction of principal on a mortgage debt and requiring use of fair market value for calculating a deficiency. In the latter, the lender, in theory, is still able to recover its full debt, whereas writing down the debt in equity potentially deprives the lender of full recovery of the contractual debt.²⁷²

²⁶⁷ See *id.* at 814. Bahls and Hunt suggested that in the context of equity, the borrowers would still owe the forgiven principal balance, but the balance would be "unsecured [by the mortgage] and presumably dischargeable in a later bankruptcy." *Id.* at 815. Similarly, Professor Cohen argued for an expansion of common law contract doctrines, particularly the excuse doctrines, to enable the modification of underwater mortgages. See Cohen, *supra* note 237, at 61–65. The judicial experience during the subprime mortgage crisis, at least thus far, has not embraced either an equitable or a common law contracts basis for modifying mortgage loan contracts.

²⁶⁸ But see *Aames Funding Corp. v. Dudley*, No. 29781/06, 2009 WL 4282857, at *2 (N.Y. Sup. Ct. Nov. 30, 2009) (invoking equitable powers in breaking a settlement impasse between the mortgagee, who required monthly payments of \$3,000 to avoid a foreclosure, and the mortgagor, who sought to pay \$2,000, by ordering the mortgagor to pay \$2,500 monthly and to avoid future delinquency, or suffer an immediate judgment of foreclosure).

²⁶⁹ See Bahls & Hunt, *supra* note 266, at 801–02.

²⁷⁰ See *First Union Trust & Savs. Bank v. Div. State Bank*, 272 Ill. App. 487, 492–93 (Ill. App. Ct. 1933) (finding the lower court without authority to declare a moratorium, as the mortgagee is suffering to the same degree as the mortgagor who let the property deteriorate and fall into disrepair); see also Bahls & Hunt, *supra* note 266, at 801 (referring, mistakenly, to this decision as a Utah case).

²⁷¹ See *Suring State Bank v. Giese*, 246 N.W. 556, 557–58 (Wis. 1933); see also Bahls & Hunt, *supra* note 266, at 802. That ruling was based on the court finding that the foreclosed property's fair market value exceeded the loan balance and did not call into question the awarding of deficiencies when the loan balance exceeded fair market value. See *Giese*, 246 N.W. at 557–58.

²⁷² Under the Bahls and Hunt proposal for equitable intervention, the forgiven principal balance would still be owed, but unsecured by the mortgage. See Bahls & Hunt, *supra* note 266, at 815. Even so, assuming that property values return in later years but the borrower defaults, the mortgage lender holding a reduced principal note would be able to foreclose only on that secured balance, and presumably would be vulnerable to other creditors capturing the additional value of the collateral.

Rather than compelling a write-down of the principal balance and reduction of the contractual interest rate, a less intrusive application of equity (albeit one without case authority in jurisdictions lacking a statutory mandate) would condition an equitable decree of foreclosure by sale on some evidence of outreach by the mortgagee toward settlement or modification negotiations. Nevertheless, practical problems with this approach include: (1) feasibility in a nonjudicial sale jurisdiction where court orders are not needed for a foreclosure sale;²⁷³ (2) difficulty of finding someone authorized to represent the lender or disparate investors in the negotiation; and (3) as exposed in jurisdictions with statutory requirements of negotiation, the uncertain texture of what constitutes bad faith conduct in settlement negotiations.²⁷⁴ Still, equity is flexible and broad enough to allow for this equitable intervention by the judge, particularly when the borrower is otherwise absent from the proceedings and the judge desires some evidence of engagement with the borrower more meaningful than mere confirmation of service of process. The existence of an economic crisis is an opportune time for powerfully flexing the dictates of equity toward settlement and restructuring of the mortgage loan, particularly given that in the throes of economic distress, the default is more likely to result from the generalized economic decline than any individualized failings of the borrower or the mortgaged property.²⁷⁵

B. Moratoria-Delay

Related to an equitable conditioning of a foreclosure decree on evidence of outreach toward settlement is the equitable moratoria on foreclosure urged by borrowers but widely rejected by courts during the Great

Judge Spinner's decision in *IndyMac Bank* lends support to an outright principal reduction—in that case a complete forgiveness of the note in equity for mortgagee misconduct. See *IndyMac Bank F.S.B. v. Yano-Horoski*, 890 N.Y.S.2d 313, 320 (N.Y. Sup. Ct. 2009), *rev'd*, 912 N.Y.S.2d 239 (N.Y. App. Div. 2010). However, his decision was reversed for lacking authority by the appellate division. See *id.* at 240–41.

²⁷³ Presumably, in a jurisdiction adopting this approach, the lender may be vulnerable to a petition in equity to enjoin the nonjudicial sale absent some showing of outreach toward settlement, thereby incentivizing the lender to initiate settlement talks prior to initiating the nonjudicial sale procedure.

²⁷⁴ Consider, for example, the various circumstances found to constitute bad faith negotiation. See *supra* Part IV.C.2; see also Freyermuth, *supra* note 23, at 1055–56 (discussing the nebulous standard of bad faith in the context of regulating the acceleration of mortgage loans).

²⁷⁵ Of course, some critics have contended that subprime borrowers knowingly solicited risky mortgage loans, thus prompting the economic crisis.

Depression. Still, some equitable authority would treat the mortgagee's initiation of foreclosure as improper when unconscionable circumstances exist. This reasoning is in contrast to the traditional view requiring misconduct by the mortgagee,²⁷⁶ suggesting the possibility of traction for delay in emergencies where great harm would otherwise result. Whether equity addresses an unconscionable initiation of foreclosure, imposes a moratorium on a judicial sale, or postpones an already scheduled nonjudicial (or sheriff) sale date, the result is effectively the same from the desperate mortgagor's perspective.

Courts in equity should willingly use their equitable authority toward these outcomes during a mortgage crisis. Relevant in the equitable determination of delay would be factors such as: (1) the presence of some economic crisis that prompted employment loss or reduction, deprived the borrower of a resale market, or imperils the prospects for realistic foreclosure sale bidding; (2) the prospects for timing of economic recovery that restores real estate values in the marketplace; (3) the borrower's payment ability in the interim during the delay; (4) the lender's good faith outreach, if any, toward modification or settlement of the loan;²⁷⁷ (5) any misconduct by the borrower or lender and loan-related parties such as loan servicers; (6) the default rate of interest which may accrue during the delay on the unpaid balance; and (7) the extent of any prejudice to the mortgagee caused by the delay in realizing on the value of the mortgaged property (reflecting the duality of equity in protecting both lender and borrower interests).²⁷⁸

²⁷⁶ See *supra* note 24 and accompanying text.

²⁷⁷ See *supra* note 273 and accompanying text.

²⁷⁸ Again, for nonjudicial sales, the role of pre-foreclosure equity is clunky, requiring the trustor-borrower to initiate an action to enjoin the sale. Here, the role of the trustee, grounded in some jurisdictions in fiduciary duty, may supply an alternate source of relief for the borrower seeking a postponement of the nonjudicial sale on compelling grounds. See *Klem v. Wash. Mut. Bank*, 295 P.3d 1179, 1187–90 (Wash. 2013) (involving a foreclosure sale held before the change in Washington law to replace the fiduciary duty of a trustee with a good faith obligation). In *Klem*, the court held that the trustee had an obligation independent of the lender to determine the bona fides of a borrower request to postpone the scheduled trustee's sale—here to permit a voluntary sale to timely conclude. See generally John E. Campbell, *Can We Trust Trustees?: Proposals for Reducing Wrongful Foreclosures*, 63 CATH. U. L. REV. (forthcoming 2014).

Regarding default interest, particularly in the event of lender misconduct, the court should have equitable discretion to reduce or forgive the accrual of interest for a specified period of time. See *supra* Part IV.D.

Admittedly, the factors listed for equitable intervention are somewhat broad and amorphous, leading one reviewer of this Article to suggest that an equity court seizing these factors could do anything it wished, which would generate intense opposition. Of course, an

C. Post-Sale Relief

In the event the foreclosure sale is held, borrowers in an economic crisis often find themselves facing a substantial deficiency judgment. Although U.S. homes on average lost one-third of their value during the subprime crisis,²⁷⁹ some pockets experienced far worse declines, such as Las Vegas, which saw homes lose almost two-thirds of their value.²⁸⁰ Although an equitable fair market value standard may protect against an oppressively low foreclosure sale bid, it does nothing to help the borrower facing a dramatic decline in actual property value. Here, borrowers hope for forgiveness of the entire deficiency, which they enjoy under the laws of some states depending on the circumstances of the loan.²⁸¹ But outcry about strategic default gaming of these antideficiency laws arose during the subprime crisis, particularly as owners of investment or vacation homes “walked away” from underwater loans.²⁸² A possible compromise between the lack of protection and the possibility of overprotection of some less-deserving borrowers by statute would rely on equitable relief. Given equity’s rather limited intervention in deficiency recoveries in which only a few courts have imposed a fair market valuation,²⁸³ it makes sense to consider state legislation giving courts equitable flexibility to deny the allowance of some or all of the claimed deficiency. Consistent with the symbiotic relationship struck between legislation and equity courts during the Great Depression,²⁸⁴ legislation might authorize courts to dispense relief in appropriate cases as they once did to postpone foreclosure sales. Of course, borrowers may balk

equity court in theory could apply any standard it pleased to determine unfairness. However, rather than conclusory opinions in equity, these factors are intended to ensure some transparency and a balance of lender and borrower interests in the equitable determination.

²⁷⁹ See Russolillo, *supra* note 109.

²⁸⁰ According to the Zillow home value index, Las Vegas homes were valued at \$303,000 in May 2006 and just \$108,000 by March 2012. See *Las Vegas Home Prices and Home Values*, ZILLOW, http://www.zillow.com/local-info/NV-Las-Vegas-home-value/r_18959/#metric=mt%3D34%26dt%3D1%26tp%3D6%26tr%3D8%26r%3D18959%252C192689%252C192820%252C192796%26el%3D0 (last visited Feb. 1, 2014).

²⁸¹ See MADISON, DWYER & BENDER, *supra* note 17, §§ 12:69-12:72.

²⁸² See Harney, *supra* note 229. These arguments, as applied to borrowers who strategically default, are not very persuasive. As with commercial borrowers who negotiate for the contractual protection of nonrecourse loans, statutory protection is part of the loan contract bargain and therefore the risk of antideficiency laws being invoked should have been priced into the loan by the sophisticated lender. Claiming the borrower’s default is immoral is an absurdity given this economic reality.

²⁸³ See *supra* Part III.

²⁸⁴ See *supra* Part IV.E.

at this statutory-equity combination that sacrifices certainty for particularized fairness—borrowers admittedly lose some of the certainty that fosters strategic default. However, this approach is offered primarily for jurisdictions without existing statutory deficiency protection rather than for advocating its adoption as a replacement for existing statutory bans.²⁸⁵

Alternatively, although going beyond the bounds of current case law, courts might embrace such protection in their independent exercise of equitable discretion during a crisis. When considering the allowance of a deficiency, either as authorized by legislation or in their equitable discretion, courts might address these relevant factors: (1) the extent of decline in property value during the economic crisis; (2) the extent to which the borrower improved or maintained the home; (3) whether the borrower used the home as a personal residence, vacation home, investment property, or for some other purpose;²⁸⁶ (4) the extent of the borrower's down payment or equity stake in the home at the outset of the loan; (5) the composition of the lender's claim—for example, the amount of any default rate of interest claimed; (6) whether the lender initiated modification or settlement talks with the borrower; (7) whether the circumstances of the loan and its foreclosure connect to traditional statutory grounds for forgiving deficiencies (for example, purchase money loans or loans foreclosed nonjudicially); (8) the borrower's financial resources and employment status; (9) the length of time the lender waited to initiate recovery of the deficiency and any

²⁸⁵ Many states already bar the recovery of deficiency judgments by statute, particularly for residential loans. See MADISON, DWYER & BENDER, *supra* note 17, §§ 12:69-12:72. Traditionally, lenders have not pursued deficiency judgments in residential loans given the scant financial resources of borrowers, the ability of borrowers to discharge that liability in bankruptcy proceedings, and lenders' desire to avoid negative publicity in the community attendant to ousting a resident and then garnishing wages and pursuing other assets. During the subprime crisis, investors holding the mortgage loan had less of a stake in local reputation and desired some return, however scant, on their broken investment. Thus, many investors, or servicing agents and lenders representing their interests, sold the deficiency claims for pennies on the dollar to collection agencies that, in turn, may have had no intention to actually file legal actions to collect the claims. These entities priced into their purchase the possibility that borrowers might be convinced, or even pressured, to voluntarily pay what they could to avoid the debilitating costs, time, and embarrassment of defending a deficiency action.

²⁸⁶ For example, during the subprime crisis, outcry surrounded some Arizona developers who took advantage of Arizona law that protected against deficiencies where the collateral had been used as a dwelling. See MADISON, DWYER & BENDER, *supra* note 17, § 18:4. By dragging a sleeping bag into a mostly-finished residence, developers might contend that they used the residential property as their dwelling. See *id.*

detrimental reliance of the borrower in the interim;²⁸⁷ (10) the borrower's prospects for replacement housing; (11) the number of family members reliant on the borrower's income and housing; (12) the lender's financial situation (for example, is the lender an institutional lender sophisticated investor, or an individual seller who supplied carryback financing?); and (13) any misconduct by the borrower or lender and loan-related parties such as loan servicers.

D. Equity for Lenders

Consistent with the origins of equity applied to mortgage loans, the above suggested standards for equity in protecting borrowers include consideration of any borrower misconduct (for example, damaging the mortgaged property) in awarding equitable relief. Mortgagees, however, may merit their own relief in the foreclosure process when statutory imperatives unduly delay foreclosure of a loan admittedly in default, injuring the mortgagee. One scenario for possible equitable intervention is where requirements of producing the mortgage note hamper foreclosure.²⁸⁸ For example, state law that limits collection to lenders possessing the note when lost may be deemed inequitable when a good faith transferee for value seeks to enforce the lost note. Moreover, relying on the requirement, whether sourced in statute or judicial procedure or precedent, that the foreclosing lender must possess the mortgage note at the outset of the foreclosure action, some courts have dismissed a foreclosure complaint when the lender acquired the note subsequent to filing the action. This dismissal allowed the foreclosing lender to refile the action, but denied cure of the defect or some midstream substitution of parties (such as substituting the real party in interest for MERS).²⁸⁹

Courts have at least two approaches in confronting these potential inequities derived from statutes or judicial procedure governing foreclosure

²⁸⁷ Cf. *MTGLQ Investors, L.P. v. Egziabher*, 39 A.3d 796, 799 (Conn. App. Ct. 2012) (sanctioning a mortgagee in equity by denying 180 days of interest for an inordinate delay between the date of initiating the action and obtaining the deficiency judgment).

²⁸⁸ See *supra* Part IV.C.

²⁸⁹ *Compare Bank of N.Y. v. Raftogianis*, 13 A.3d 435, 459–60 (N.J. Super. Ct. Ch. Div. 2010) (dismissing a foreclosure complaint without prejudice to the note holder with possession at the date of filing to institute a new action), *with* *Mortg. Elec. Registration Sys., Inc. v. Saunders*, 2 A.3d 289, 297–301 (Me. 2010) (finding that although MERS lacked standing to initiate the judicial foreclosure action because it lacked possession of the note, the lower court properly substituted Deutsche Bank as the holder in place of MERS; hence, rejecting the argument that a substitution of parties could not cure a jurisdictional defect and that the bank was precluded as a nonparty from filing a motion of substitution of parties).

requisites, particularly in the throes of some broader economic crisis. They can either construe the foreclosure requirements flexibly to permit a fair outcome, or rely on judicial equity—at least where the applicable statute does not explicitly deny equitable intervention. Some of the same factors identified above for mortgagor relief are relevant in the court's determination of whether to relieve the mortgagee from some statutory burden that may be inequitable and unduly delay or prevent the foreclosure of a defaulted loan. These include: (1) the lender's good faith outreach, if any, toward modification or settlement of the loan; (2) any misconduct by the borrower or lender and loan-related parties such as loan servicers; (3) the default rate of interest which may accrue during any delay in recovering on the unpaid balance; and (4) the extent of any prejudice to the mortgagee caused by any delay in realizing on the value of the mortgaged property. Factors unique to statutory compliance would include: (1) the purpose of the statutory protection; (2) the ease of mortgagee compliance with the obligation; and (3) whether compliance comported with lender custom or was newly announced by the court and not fairly anticipated by lenders.

VI. CONCLUSION

In the thick of the subprime crisis in 2010, during a panel covering significant case law developments at a conference of the American College of Mortgage Attorneys in Quebec City, Canada, the author discussed Judge Spinner's equity rulings, particularly his decision in *IndyMac Bank, F.S.B. v. Yano-Horoski*,²⁹⁰ in which he cancelled the entire mortgage note and security instrument.²⁹¹ Looking back, the discussion was too harsh on Judge Spinner's ruling; however, the appellate court did agree by striking down Judge Spinner's dramatic equitable cancellation just a few weeks later.²⁹² Since then, the author's appreciation for the role of equity has grown, as has his understanding of how limited a role equity has played in times of financial crisis. Despite the pragmatic suggestions offered above for applying judicial equity in a mortgage crisis, equity jurisprudence does need more Judge Spinners, even if appellate courts rein them in. Judges need to push the limits of equity during fiscal emergencies when legislatures and lenders fail to react to the imperatives and desperation of borrowers, particularly those losing their residences. Rather than being rogues and renegades, these judges would

²⁹⁰ 890 N.Y.S.2d 313 (N.Y. Sup. Ct. 2009), *rev'd*, 912 N.Y.S.2d 239 (N.Y. App. Div. 2010).

²⁹¹ *See id.* at 320.

²⁹² *See IndyMac Bank*, 912 N.Y.S.2d at 240–41.

be honoring the origins and sweeping maxims of equity when they are most urgently needed. Despite their indeterminacy, equitable maxims are worth remembering, by the financial community and its lawyers, throughout the collection process, in good times and bad. When in doubt, they might simply aim to do what “ought to be done.”